California Franchise Tax Board **KATHLEEN CONNELL**

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SUMMARY OF FEDERAL INCOME TAX CHANGES ---- 1999

Laws Affected:

Personal Income Tax Bank and Corporation Tax Administration of Franchise and Income Tax Laws

SUMMARY OF FEDERAL INCOME TAX CHANGES 1999

Prepared by the Staff of the FRANCHISE TAX BOARD

State of California

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This report is submitted in fulfillment of the requirement in

Revenue and Taxation Code Section 19522.



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SUMMARY OF FEDERAL INCOME TAX CHANGES - 1999 Prepared by the Staff of the FRANCHISE TAX BOARD State of California

Executive Summary

During 1999, the Internal Revenue Code or its application was changed by:

PUBLIC <u>LAW</u>	TITLE
106-21	TAX BENEFITS FOR SERVICES AS PART OF OPERATION ALLIED FORCE
106-36	MISCELLANEOUS TRADE AND TECHNICAL CORRECTIONS ACT OF 1999
106-58	APPROPRIATIONS, 2000
106-170	TICKET TO WORK AND WORK INCENTIVES IMPROVEMENT ACT OF 1999

This report explains the new federal laws along with the effective dates, the corresponding California law (if any), including an explanation of any changes made in response to the new federal law, and the impact on California revenue were California to conform to the federal changes. This Report also contains citations to the section numbers of the Public Law, the Internal Revenue Code, and the California Revenue and Taxation Code impacted by the federal changes.

Following is a list of California tax provisions that expire in 2000.

Calif. Sunset	Calif. Section	Federal Section	Fed. Sect.	Description and Comments
01/01/00	24357.9	12/31/00 1		Deduction: Augmented Corporate Computer Contributions
12/31/00	17279.4 24369.4	12/31/01		Deduction: Expensing of Environmental Remediation Costs (Brownfields)

Exhibit A contains a complete listing of expiring provisions in California law.

Exhibit B contains a revenue table.

TAX BENEFITS FOR SERVICES AS PART OF OPERATION ALLIED FORCE (P.L. 106-21)

Section Section Title

Tax Benefits of Military Personnel Serving in Combat Zones Extended to Hazardous Duty Area

Background

Federal law provides special rules for military personnel serving in combat zones. A combat zone is defined in Internal Revenue Code (IRC) Section 112 and is designated by the President of the United States under an Executive Order. The following rules apply to military personnel serving in combat zones or spouses thereof:

- 1. A spouse of a military person, who was in a missing in action status within a combat zone, may file as surviving spouse for periods following the date of determination of death if certain other rules are met.
- 2. Compensation received while serving in a combat zone is excluded from gross income. For commissioned officers, the exclusion is limited to the maximum enlisted amount.
- 3. Any income of a decedent (whose death is as a result of serving in a combat zone) during the period from the year the decedent first served in a combat zone until the year of the decedent's death is exempt from income tax.
- 4. The transfer of the taxable estate of a decedent whose death is a result of serving in a combat zone is excluded from certain estate tax.
- 5. Phone service originating within a combat zone is exempt from federal excise taxes.
- 6. Compensation excluded under item 2, above, is considered wages for other purposes of the IRC (e.g., employment taxes and the earned income credit).
- 7. Permits a spouse of a serviceperson missing in action while serving in a combat zone to file a joint tax return under certain circumstances.
- 8. Extends various deadlines (including the time to file a tax return) and pay tax by the amount of time served in a combat zone plus 180 days.

On April 13, 1999, the President of the United States issued Executive Order 13119, designating Federal Republic of Yugoslavia (Serbia/Montenegro), Albania, the Adriatic Sea, the Ionian Sea north of the 39th parallel, and the airspace above as a combat zone. The commencement date of combat activities in the combat zone is March 24, 1999.

New Federal Law

The provision provides that a "qualified hazardous duty area" shall be treated as if it were a combat zone under Section 112 of the Internal Revenue Code (IRC). A qualified hazardous duty area is defined as any area of Federal Republic of Yugoslavia (Serbia/Montenegro), Albania, the Adriatic Sea and the

TAX BENEFITS FOR SERVICES AS PART OF OPERATION ALLIED FORCE (P.L. 106-21)

Ionian Sea (above the $39^{\rm th}$ parallel) during the period that any serviceperson is entitled to special pay under Section 310 of Title 37 of the United States Code (USC) relating to services performed subject to hostile fire or imminent danger for services performed in such area. These areas are the same areas that the President declared as a combat zone in Executive Order 13119.

Because the President designated the same areas as a combat zone, this provision has no immediate effect. The provision will have effect when the President removes the designated areas from a combat zone, and personnel in the designated areas continue to receive payments under Section 310 of Title 37 of the USC.

Effective Date

The provision is effective on March 24, 1999.

Current California Law

California conforms to IRC 112 and because the President designated the above areas as a combat zone, item 1, 2, 3, and 8 referred to above (which relate to income taxation) receive the same treatment for California as federal purposes. Item 4, relating to estate taxation, is not applicable to California. Item 5, relating to employment taxes, is administered by the Employment Development Department. Item 6, relating to excise taxes, is administered by the Board of Equalization. If a joint return may be filed for federal purposes, a joint return may be filed for California purposes. Consequently, item 7 applies for California purposes.

Impact on California Revenue

Because the designated areas are a combat zone, this provision has no revenue effect.

MISCELLANEOUS TRADE AND TECHNICAL CORRECTIONS ACT OF 1999 (P.L. 106-36)

Section Section Title

3001 Property Subject to a Liability Treated in Same Manner as

Assumption of Liability

Background

Prior federal law provides that the transferor of property recognizes no gain or loss if the property is exchanged solely for qualified stock in a controlled corporation (sec. 351). The assumption by the controlled corporation of a liability of the transferor (or the acquisition of property "subject to" a liability) generally will not cause the transferor to recognize gain. However, under section 357(c), the transferor does recognize gain to the extent that the sum of the assumed liabilities, together with the liabilities to which the transferred property is subject, exceeds the transferor's basis in the transferred property. If the transferred property is "subject to"' a liability, Treasury regulations indicate that the amount of the liability is included in the calculation regardless of whether the underlying liability is assumed by the controlled corporation. Similar rules apply to reorganizations described in section 368(a)(1)(D).

The gain recognition rule of section 357(c) is applied separately to each transferor in a section 351 exchange.

The basis of the property in the hands of the controlled corporation equals the transferor's basis in such property, increased by the amount of gain recognized by the transferor, including section 357(c) gain.

New Federal Law (IRC Sec. 357)

Under the provision, the distinction between the assumption of a liability and the acquisition of an asset subject to a liability generally is eliminated. First, except as provided in Treasury regulations, a recourse liability (or any portion thereof) is treated as having been assumed if, as determined on the basis of all facts and circumstances, the transferee has agreed to, and is expected to satisfy the liability or portion thereof (regardless of whether the transferor has been relieved of the liability). Thus, where more than one person agrees to satisfy a liability or portion thereof, only one would be expected to satisfy such liability or portion thereof. Second, except as provided in Treasury regulations, a nonrecourse liability (or any portion thereof) is treated as having been assumed by the transferee of any asset that is subject to the liability. However, this amount is reduced in cases where an owner of other assets subject to the same nonrecourse liability agrees with the transferee to, and is expected to, satisfy the liability (up to the fair market value of the other assets, determined without regard to section 7701(g)).

In determining whether any person has agreed to and is expected to satisfy a liability, all facts and circumstances are to be considered. In any case where the transferee does agree to satisfy a liability, the transferee also

MISCELLANEOUS TRADE AND TECHNICAL CORRECTIONS ACT OF 1999 (P.L. 106-36)

will be expected to satisfy the liability in the absence of facts indicating the contrary.

In determining any increase to the basis of property transferred to the transferee as a result of gain recognized because of the assumption of liabilities under section 357, in no event will the increase cause the basis to exceed the fair market value of the property (determined without regard to $\sec. 7701(g)$).

If gain is recognized to the transferor as the result of an assumption by a corporation of a nonrecourse liability that also is secured by any assets not transferred to the corporation, and if no person is subject to federal income tax on such gain, then for purposes of determining the basis of assets transferred, the amount of gain treated as recognized as the result of such assumption of liability shall be determined as if the liability assumed by the transferee equaled such transferee's ratable portion of the liability, based on the relative fair market values (determined without regard to sec. 7701(g)) of all assets subject to such nonrecourse liability. In no event will the gain cause the resulting basis to exceed the fair market value of the property (determined without regard to sec. 7701(g)).

The Treasury Department has authority to prescribe such regulations as may be necessary to carry out the purposes of the provision. This authority includes the authority to specify adjustments in the treatment of any subsequent transactions involving the liability, including the treatment of payments actually made with respect to any liability as well as appropriate basis and other adjustments with respect to such payments. Where appropriate, the Treasury Department also may prescribe regulations which provide that the manner in which a liability is treated as assumed under the provision is applied elsewhere in the Code.

Effective Date

The provision is effective for transfers on or after October 19, 1998. No inference regarding the tax treatment under present law is intended

Current California Law (R&TC Sec. 17321 & 24451)

California is in conformity with federal law as it relates to the transfer of assets to a controlled corporation prior to the passage of the Miscellaneous Trade and Technical Corrections Act Of 1999.

Impact on California Revenue

The revenue impact from conforming to these provisions would be a \$1 million gain in 2000-01 and 2001-02, and a \$1.5 million gain in 2002-03.

APPROPRIATIONS, 2000 (P.L. 106-58)

Section Section Title

650 Itemized Income Tax Receipt

New Federal Law

The provision requires the Secretary of the Treasury, by April 15, 2000, to establish an interactive program on a website where any taxpayer may generate an itemized receipt showing a proportionate allocation (in money terms) of the taxpayer's total tax payments among the major expenditure categories. The provision lists nine major expenditure categories and examples of 19 more specific expenditure items that must be listed on the receipt.

The taxpayer only needs the amount of tax paid to generate the receipt. Identifying information of the taxpayer shall not be required.

Effective Date

The provision is effective on September 15, 1999.

Current California Law

The department maintains a website where individual taxpayers may obtain a tax receipt at www.ftb.ca.gov/taxcalc/welcome/asp. The tax receipt provides detailed lists of state expenditures, including major expenditures on a percentage basis. The taxpayer needs only the amount of tax paid to generate the receipt.

Impact on California Revenue

Not applicable.

Section Section Title

405 Authorization for States to Permit Annual Wage Reports

Background

The Social Security Domestic Employment Reform Act of 1994 (P.L. 103-387) changed certain Social Security and Medicare tax rules. Specifically, that Act provided that domestic service employers (that is, individuals employing maids, gardeners, babysitters, and the like) would no longer owe taxes for any domestic employee who earned less than \$1,000 per year from the employer. In addition, that Act simplified certain reporting requirements. Domestic employers were no longer required to file quarterly returns regarding Social Security and Medicare taxes, nor the annual Federal Unemployment Tax Act (FUTA) return. Instead, all federal reporting was consolidated on an annual Schedule H filed at the same time as the employer's personal income tax return.

New Federal Law

The provision allows States the option of permitting domestic service employers to file annual rather than quarterly wage reports pursuant to section 1137 of the Social Security Act.

Effective Date

This provision is effective as of the date of enactment.

Current California Law

Employment taxes are administered by the Employment Development Department (EDD).

Impact on California Revenue

Defer to the EDD.

Section Section Title

Simplification of Foster Child Definition under Earned Income Credit

Background

For purposes of the earned income credit (EIC), qualifying children may include foster children who reside with the taxpayer for a full year, if the taxpayer cares for the foster children as the taxpayer's own children. (Code section 32(c)(3)(B)(iii)). All EIC qualifying children (including foster

children) must either be under the age of 19 (24 if a full-time student) or permanently and totally disabled. There is no requirement that the foster child either be (1) placed in the household by a foster care agency or (2) a relative of the taxpayer.

New Federal Law

For purposes of the EIC, a foster child is defined as a child who (1) is cared for by the taxpayer as if he or she were the taxpayer's own child, (2) has the same principal place of abode as the taxpayer for the taxpayer's entire taxable year, and (3) either is the taxpayer's brother, sister, stepbrother, stepsister, or descendant (including an adopted child) of any such relative, or was placed in the taxpayer's home by an agency of a state or one of its political subdivisions or by a tax-exempt child placement agency licensed by a state.

Effective Date

The provision is effective for taxable years beginning after December 31, 1999.

Current California Law

California does not have a comparable credit to federal EIC.

Impact on California Revenue

Not applicable.

Section Section Title

501 Extend Minimum Tax Relief for Individuals

Background

Federal law provides for certain nonrefundable personal tax credits (i.e., the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child tax credit, the credit for interest on certain home mortgages, the HOPE Scholarship and Lifetime Learning credits, and the D.C. homebuyer's credit). Except for taxable years beginning during 1998, these credits are allowed only to the extent that the individual's regular income tax liability exceeds the individual's tentative minimum tax, determined without regard to the minimum tax foreign tax credit. For taxable years beginning during 1998, these credits are allowed to the extent of the full amount of the individual's regular tax (without regard to the tentative minimum tax).

An individual's tentative minimum tax is an amount equal to (1) 26% of the first \$175,000 (\$87,500 in the case of a married individual filing a separate return) of alternative minimum taxable income (AMTI) in excess of a phasedout exemption amount and (2) 28% of the remaining AMTI. The maximum tax rates on net capital gain used in computing the tentative minimum tax are the same as under the regular tax. AMTI is the individual's taxable income adjusted to take account of specified preferences and adjustments. The exemption amounts are: (1) \$45,000 in the case of married individuals filing a joint return and surviving spouses; (2) \$33,750 in the case of other unmarried individuals; and (3) \$22,500 in the case of married individuals filing a separate return, estates and trusts. The exemption amounts are phased out by an amount equal to 25% of the amount by which the individual's AMTI exceeds (1) \$150,000 in the case of married individuals filing a joint return and surviving spouses, (2) \$112,500 in the case of other unmarried individuals, and (3) \$75,000 in the case of married individuals filing separate returns or an estate or a trust. These amounts are not indexed for inflation.

For families with three or more qualifying children, a refundable child credit is provided, up to the amount by which the liability for social security taxes exceeds the amount of the earned income credit (section 24(d)). For taxable years beginning after 1998, the refundable child credit is reduced by the amount of the individual's minimum tax liability (i.e., the amount by which the tentative minimum tax exceeds the regular tax liability).

New Federal Law (IRC Sections 24 and 26)

The Ticket to Work and Work Incentives Improvement Act Of 1999 (the Act) extends to taxable years beginning in 1999 the provision that allows the nonrefundable credits to offset the individual's regular tax liability in full (as opposed to only the amount by which the regular tax exceeds the tentative minimum tax). For taxable years beginning in 2000 and 2001, the personal nonrefundable credits may offset both the regular tax and the alternative minimum tax. The foreign tax credit will be allowed before the personal credits in computing the regular tax for these years. The refundable child credit will not be reduced by the amount of an individual's minimum tax in taxable years beginning in 1999, 2000, and 2001.

Effective Date

This provision is effective for taxable years beginning in 1999, 2000 and 2001.

Current California Law (R&TC Section 17039)

California law is generally in conformity with federal law as it relates to the computation of AMT and tentative minimum tax. The amounts included in the computation may differ due to other differences in the laws. Also, California's AMT rate is 7%.

Prior to AB 1637 (Ch. 930, Stats. 1999), the only "personal" type credit allowed to reduce the regular tax amount below the tentative minimum tax was the renter's credit. Effective beginning in the 1999 tax year, AB 1637 eliminated the tentative minimum tax limitation on personal exemption credits by allowing the "exemption" credits to reduce regular tax below tentative minimum tax. Exemption credits include the personal, dependent, blind and senior credits only. California law still limits other "personal" type credits to the tentative minimum tax level. Other "personal" type credits include joint custody head of household, dependent parent, senior head of household and child adoption credit. The senior head of household and child adoption credits have AGI limitations. The interaction of the AGI limitations and the AMT threshold amounts reduce the number of taxpayers taking one of these two credits being affected by the tentative minimum tax limitation.

Impact on California Revenue

Based on model simulations, the revenue loss for eliminating the tentative minimum tax interaction with regard to "other" personal credits would be negligible.

Section Section Title

502 Extend Research and Experimentation Tax Credit and Increase the Alternative Incremental Rates

Background

Section 41 provides for a research tax credit equal to 20% of the amount by which a taxpayer's qualified research expenditures for a taxable year exceed its base amount for that year. The research tax credit expired and generally does not apply to amounts paid or incurred after June 30, 1999.

Except for certain university basic research payments made by corporations, the research tax credit applies only to the extent that the taxpayer's qualified research expenditures for the current taxable year exceed its base amount. The base amount for the current year generally is computed by multiplying the taxpayer's "fixed-base percentage" by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenditures and had gross receipts during each of at least three years from 1984 through 1988, then its "fixed-base percentage" is the ratio that its total qualified research expenditures for the 1984-1988 period bears to its total gross receipts for that period (subject to a maximum ratio of .16). All other taxpayers (so-called "start-up firms") are assigned a fixed-base percentage of 3%. Expenditures attributable to research that is conducted outside the United States do not enter into the credit computation.

Taxpayers are allowed to elect an alternative incremental research credit regime. If a taxpayer elects to be subject to this alternative regime, the taxpayer is assigned a three-tiered fixed-base percentage (that is lower than the fixed-base percentage otherwise applicable under present law) and the credit rate likewise is reduced. Under the alternative credit regime, a credit rate of 1.65% applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1% (i.e., the base amount equals 1% of the taxpayer's average gross receipts for the four preceding years), but do not exceed a base amount computed by using a fixed-base percentage of 1.5%. A credit rate of 2.2% applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1.5%, but do not exceed a base amount computed by using a fixed-base percentage of 2%. A credit rate of 2.75% applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 2%. An election to use the alternative incremental credit regime may be made for any taxable year beginning after June 30, 1996, and such an election applies to that taxable year and all subsequent years (in the event that the credit subsequently is extended) unless revoked with the consent of the Secretary of the Treasury.

New Federal Law (IRC Section 41)

The Act extends the research tax credit for five years--i.e., generally, for the period July 1, 1999, through June 30, 2004. In addition, the provision increases the credit rate applicable under the alternative incremental research credit one percentage point per step, that is from 1.65% to 2.65% when a taxpayer's current-year research expenses exceed a base amount of 1%, but do not exceed a base amount of 1.5%; from 2.2% to 3.2% when a taxpayer's current-year research expenses exceed a base amount of 1.5%, but do not exceed a base amount of 2%; and from 2.75% to 3.75% when a taxpayer's current-year research expenses exceed a base amount of 2%.

The Act also expands the definition of qualified research to include research undertaken in Puerto Rico and possessions of the United States. However, any employee compensation or other expense claimed for computation of the research credit may not also be claimed for the purpose of any credit allowable under section 30A (Puerto Rico economic activity credit) or under section 936 (Puerto Rico and possession tax credit).

Research tax credits that are attributable to the period beginning on July 1, 1999, and ending on September 30, 2000, may not be taken into account in determining any amount required to be paid for any purpose under the Internal Revenue Code prior to October 1, 2000. On or after October 1, 2000, such credits may be taken into account through the filing of an amended return, an application for expedited refund, an adjustment of estimated taxes, or other means that are allowed by the Code. The prohibition on taking credits attributable to the period beginning on July 1, 1999, and ending on September 30, 2000, into account as payments prior to October 1, 2000, extends to the determination of any penalty or interest under the Code. For example, the amount of tax required to be shown on a return that is due prior to October

1, 2000 (excluding extensions) may not be reduced by any such credits. In addition, Congress clarified that deductions under section 174 are reduced by credits allowable under section 41 as under present law, not withstanding the delay in taking the credit into account created by this provision.

Similarly, research tax credits that are attributable to the period beginning October 1, 2000, and ending on September 30, 2001, may not be taken into account in determining any amount required to be paid for any purpose under the Internal Revenue Code prior to October 1, 2001. On or after October 1, 2001, such credits may be taken into account through the filing of an amended return, an application for expedited refund, an adjustment of estimated taxes, or other means that are allowed by the Code. Likewise, the prohibition on taking credits attributable to the period beginning on October 1, 2000, and ending on September 30, 2001, into account as payments prior to October 1, 2001, extends to the determination of any penalty or interest under the Code.

In extending the research credit, Congress was concerned that the definition of qualified research be administered in a manner that is consistent with the intent Congress has expressed in enacting and extending the research credit. The Secretary was urged to consider carefully the comments he has and may receive regarding the proposed regulations relating to the computation of the credit under section 41(c) and the definition of qualified research under section 41(d), particularly regarding the "common knowledge" standard. The rapid pace of technological advance was noted, especially in service-related industries, and the Secretary was urged to consider carefully the comments he has and may receive in promulgating regulations in connection with what constitutes "internal use" with regard to software expenditures. Congress also observed that software research, that otherwise satisfies the requirements of section 41, which is undertaken to support the provision of a service, should not be deemed "internal use" solely because the business component involves the provision of a service.

Congress wished to reaffirm that qualified research is research undertaken for the purpose of discovering new information which is technological in nature. For purposes of applying this definition, new information is information that is new to the taxpayer, is not freely available to the general public, and otherwise satisfies the requirements of section 41. Employing existing technologies in a particular field or relying on existing principles of engineering or science is qualified research, if such activities are otherwise undertaken for purposes of discovering information and satisfy the other requirements under section 41.

Congress was also concerned about unnecessary and costly taxpayer record keeping burdens and reaffirms that eligibility for the credit is not intended to be contingent on meeting unreasonable record keeping requirements.

Effective Date

The extension of the research credit is effective for qualified research expenditures paid or incurred during the period July 1, 1999, through June

30, 2004. The increase in the credit rate under the alternative incremental research credit is effective for taxable years beginning after June 30, 1999.

Current California Law (R&TC Section 17052.12 & 23609)

Existing state law conforms with specific modifications to the federal research credit prior to the enactment of the Act, as follows:

- For corporate taxpayers engaged in specified biopharmaceutical research and biotech research and development, the definition of "qualified organization" includes hospitals run by public universities and certain cancer centers.
- "Basic research" must be conducted in California to qualify for the California credit.
- Research that has a specific commercial objective may qualify as "basic research."
- Specifies that "qualified research expense" does not include any amount paid or incurred for tangible personal property that is eligible for the sales tax exemption provided under Section 6378 of the R&TC (relating to teleproduction and postproduction).
- The credit percentage is now 12% for "qualified research" (increased for 1999 and later years by SB 705 (Ch. 77, Stats. 1999) and 24% for corporations for "basic research." To duplicate the federal provision that allows the credit for "basic research" payments only to corporate taxpayers, the Bank and Corporation Tax Law (B&CTL) allows the credit based on "qualified research" expenses and "basic research" payments, while the Personal Income Tax Law (PITL) allows the credit only for "qualified research" expenses.
- The state alternative incremental credit amount is 80% of the prior federal alternative incremental credit. This equates to 1.31%, 1.76% and 2.20%.
- California taxpayers may make the alternative incremental credit election at any one time, instead of having a window period for making the election that is comparable to the federal credit. Also, taxpayer's federal election is not binding for state purposes.
- The state definition of "gross receipts" for purposes of the credit differs from that used in the federal credit.
- The termination dates provided under federal law do not apply to state law. The California research credit is allowed indefinitely for taxable and income years beginning on or after January 1, 1987.

If the credit exceeds the tax, the excess is carried over.

Impact on California Revenue

Revenue losses under the PIT and B&CT laws from higher alternative incremental research credit rates are estimated to be as follows:

Estimated Revenue Impact of Section 502				
Effective for Tax Years After December 31, 1999				
Enactment Assumed After 6/30/99				
(\$In Millions)				
2000-01	2001-02	2002-03	2003-04	
-\$13	-\$22	-\$27	-\$30	

The above revenue impact was estimated as follows. First, the revenue loss due to AIRC under existing B&CT law was estimated for 1994 using B&CT samples as well as other corporate financial data. Next, the revenue loss due to AIRC under the proposed higher credit rates (i.e. 80% of the new federal rates) was computed using the same data. The difference between these two amounts was the B&CT revenue impact of the proposal. The revenue losses were extrapolated using reported aggregate R&D credits claimed by California corporations from 1994 to 1997, and DOF projected annual growth rates of corporate profits beyond 1997. Finally, the revenue impact under PIT was assumed to be equal to one percent of the B&CT impact and was added to the corporate impact.

Section Section Title

503 Extend Exceptions Under Subpart F for Active Financing Income

Background

Under the subpart F rules, 10% U.S. shareholders of a controlled foreign corporation (CFC) are subject to U.S. tax on certain income earned by the CFC, regardless of whether such income is distributed to the shareholders. The income subject to current inclusion under the subpart F rules includes, among other things, foreign personal holding company income and insurance income. In addition, 10% U.S. shareholders of a CFC are subject to current inclusion with respect to their shares of the CFC's foreign base company services income (i.e., income derived from services performed for a related person outside the country in which the CFC is organized).

Foreign personal holding company income generally consists of the following: (1) dividends, interest, royalties, rents, and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and REMICs; (3) net gains from commodities transactions; (4) net gains from foreign currency transactions; (5) income

that is equivalent to interest; (6) income from notional principal contracts; and (7) payments in lieu of dividends.

Insurance income subject to current inclusion under the subpart F rules includes any income of a CFC attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the CFC's country of organization. Subpart F insurance income also includes income attributable to an insurance contract in connection with risks located within the CFC's country of organization, as the result of an arrangement under which another corporation receives a substantially equal amount of consideration for insurance of other-country risks. Investment income of a CFC that is allocable to any insurance or annuity contract related to risks located outside the CFC's country of organization is taxable as subpart F insurance income (Prop. Treas. Reg. section 1.953 1(a)).

Temporary exceptions from foreign personal holding company income, foreign base company services income, and insurance income apply for subpart F purposes for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business (so-called "active financing income"). These exceptions are applicable only for taxable years beginning in 1999. Temporary exceptions from the subpart F provisions for certain active financing income applied only for taxable years beginning in 1998. Those exceptions were extended and modified as part of the present-law provision.

With respect to income derived in the active conduct of a banking, financing, or similar business, a CFC is required to be predominantly engaged in such business and to conduct substantial activity with respect to such business in order to qualify for the exceptions. In addition, certain nexus requirements apply, which provide that income derived by a CFC or a qualified business unit (QBU) of a CFC from transactions with customers is eligible for the exceptions if, among other things, substantially all of the activities in connection with such transactions are conducted directly by the CFC or QBU in its home country, and such income is treated as earned by the CFC or QBU in its home country for purposes of such country's tax laws. Moreover, the exceptions apply to income derived from certain cross border transactions, provided that certain requirements are met. Additional exceptions from foreign personal holding company income apply for certain income derived by a securities dealer within the meaning of section 475 and for gain from the sale of active financing assets.

In the case of insurance, in addition to a temporary exception from foreign personal holding company income for certain income of a qualifying insurance company with respect to risks located within the CFC's country of creation or organization, certain temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of a qualifying branch of a qualifying insurance company with respect to risks located within the home country of the branch, provided certain requirements are met under each of the exceptions. Further, additional temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of certain CFCs or branches with respect to

risks located in a country other than the United States, provided that the requirements for these exceptions are met

New Federal Law (Sections 953 and 954)

The Act extends for two years the present-law temporary exceptions from subpart F foreign personal holding company income, foreign base company services income, and insurance income for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business.

The Act also clarifies that if the temporary exception from subpart F insurance income does not apply for a taxable year beginning after December 31, 2001, section 953(a) is to be applied to such taxable year in the same manner as it would for a taxable year beginning in 1998 (i.e., under the law in effect before amendments to section 953(a) were made in 1998). Thus, for future periods in which the temporary exception relating to insurance income is not in effect, the same-country exception from subpart F insurance income applies as under prior law.

Effective Date

The provision is effective for taxable years of foreign corporations beginning after December 31, 1999, and before January 1, 2002, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.

Current California Law (R&TC Section 25110)

In general, California does not conform to the federal rules relating to controlled foreign corporations. However, for California water's-edge purposes, a controlled foreign corporation (CFC) is required to be included in the water's-edge combined report if the CFC has Subpart F income defined in Section 952 of the Internal Revenue Code.

The income and apportionment factor of the CFC included within a water's-edge combined report is the CFC's net income and apportionment factor determined under the Revenue and Tax Code multiplied by the ratio of subpart F income defined by Section 952 of the Internal Revenue Code over earnings and profits defined in Section 964 of the Internal Revenue Code.

The deemed dividend treatment for subpart F income prescribed by section 951 of the Code is not applicable for California purposes

Under California law, insurance companies are generally not subject to the income or franchise tax. Instead, insurers pay a tax based generally on premiums received during the year from business transacted in California. The gross premiums tax rate is set each year and administered by the State Board of Equalization. Since 1990, the tax has been set at 2.35%.

Impact on California Revenue

Based on a review of issues for state tax purposes by audit staff, this provision affecting certain financial service corporations filing on a water's-edge basis with controlled foreign corporations would result in minor revenue losses annually on the order of \$500,000 for 2000-1 through 2002-03. It is assumed the provision would be effective with transfers made in taxable years beginning after December 31, 1999, through December 31, 2001. Largely due to the indicated entity requirements, California's impact is less than the otherwise standard proportional estimate of the federal impact.

Section Section Title

Extend Suspension of Net Income Limitation on Percentage Depletion from Marginal Oil and Gas Wells

Background

The Code permits taxpayers to recover their investment in oil and gas wells through depletion deductions. In the case of certain properties, the deductions may be determined using the percentage depletion method. Among the limitations that apply in calculating percentage depletion deductions is a restriction that, for oil and gas properties, the amount deducted may not exceed 100% of the net income from that property in any year (section 613(a)).

Special percentage depletion rules apply to oil and gas production from "marginal" properties (section 613A(c)(6)). Marginal production is defined as domestic crude oil and natural gas production from stripper well property or from property substantially all of the production from which during the calendar year is heavy oil. Stripper well property is property from which the average daily production is 15 barrel equivalents or less, determined by dividing the average daily production of domestic crude oil and domestic natural gas from producing wells on the property for the calendar year by the number of wells. Heavy oil is domestic crude oil with a weighted average gravity of 20 degrees API or less (corrected to 60 degrees Fahrenheit). Under one such special rule, the 100%-of-net-income limitation does not apply to domestic oil and gas production from marginal properties during taxable years beginning after December 31, 1997, and before January 1, 2000.

New Federal Law (IRC Section 613A)

The Act extends the present-law suspension of the 100%-of-net-income limitation with respect to oil and gas production from marginal wells to include taxable years beginning after December 31, 1999, and before January 1, 2002.

Current California Law (R&TC Section 17681 & 24831)

California law is in full conformity with federal law, as it read on January 1, 1998, and as it relates to percentage depletion of oil and gas wells, including the temporary suspension of the 100%-of-net-income limitation. Under California law the limitation applies again for taxable or income years beginning on or after January 1, 2000.

Impact on California Revenue

Revenue losses due to this provision for fiscal years 2000-01, 2001-02, and 2002-3 are projected to be \$0.5 million, \$1 million, and \$0.5 million, respectively.

The revenue impact was estimated using micro-level taxpayer data from the California Franchise Tax Board's bank and corporation sample. The annual number of barrels by taxpayers was estimated on the basis of the taxpayer's California sales assuming a price of \$8 per barrel. It was assumed that the number of barrels by a taxpayer on marginal wells does not exceed 35,000 annually. It was also assumed that 90% of the revenue directly relates to the sale of oil and gas. Finally, it was assumed that 70% of the California oil production is heavy oil. This percentage was obtained from the California Department of Conservation. The estimate accounts for both corporations and partnerships.

Section Section Title

505 Extend the Work Opportunity Tax Credit

Background

The work opportunity tax credit (WOTC), which expired on June 30, 1999, was available on an elective basis for employers hiring individuals from one or more of eight targeted groups. The credit equals 40% (25% for employment of 400 hours or less) of qualified wages. Generally, qualified wages are wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual began work for the employer. The maximum credit per employee is \$2,400 (40% of the first \$6,000 of qualified first-year wages). With respect to qualified summer youth employees, the maximum credit is \$1,200 (40% of the first \$3,000 of qualified first-year wages).

The employer's deduction for wages is reduced by the amount of the credit.

The eight targeted groups are: (1) families eligible to receive benefits under the Temporary Assistance for Needy Families (TANF) Program; (2) highrisk youth; (3) qualified ex-felons; (4) vocational rehabilitation referrals; (5) qualified summer youth employees; (6) qualified veterans; (7) families

receiving food stamps; and (8) persons receiving certain Supplemental Security Income (SSI) benefits.

No credit is allowed for wages paid to employees who work less than 120 hours in the first year of employment.

The credit is effective for wages paid or incurred to a qualified individual who began work for an employer before July 1, 1999.

New Federal Law (IRC Section 51)

The Act extends the work opportunity tax credit for 30 months (through December 31, 2001) and clarifies the definition of first year of employment for purposes of the WOTC.

Effective Date

The provision is effective for wages paid or incurred to qualified individuals who begin work for the employer on or after July 1, 1999, and before January 1, 2002.

Current California Law

California does not conform to this federal credit. However, the local agency military base recovery area (LAMBRA) and enterprise zone hiring credits must be reduce by any allowable federal WOTC or Welfare-To-Work Tax Credit.

Impact on California Revenue

Not applicable.

Section Section Title

505 Extend the Welfare-To-Work Tax Credit

Background

The Code provides to employers a tax credit on the first \$20,000 of eligible wages paid to qualified long-term family assistance (AFDC or its successor program) recipients during the first two years of employment. The credit is 35% of the first \$10,000 of eligible wages in the first year of employment and 50% of the first \$10,000 of eligible wages in the second year of employment. The maximum credit is \$8,500 per qualified employee.

Qualified long-term family assistance recipients are: (1) members of a family that has received family assistance for at least 18 consecutive months ending on the hiring date; (2) members of a family that has received family assistance for a total of at least 18 months (whether or not consecutive) after the date of enactment of this credit if they are hired within two years

after the date that the 18-month total is reached; and (3) members of a family who are no longer eligible for family assistance because of either federal or state time limits, if they are hired within two years after the federal or state time limits made the family ineligible for family assistance.

Eligible wages include cash wages paid to an employee plus amounts paid by the employer for the following: (1) educational assistance excludable under a section 127 program; (2) certain health plan coverage for the employee; and (3) dependent care assistance excludable under section 129.

The welfare to work credit is effective for wages paid or incurred to a qualified individual who begins work for an employer on or after January 1, 1998, and before July 1, 1999.

New Federal Law (IRC Section 51A)

The Act extends the welfare-to-work tax credit for 30 months (through December 31, 2001.)

Effective Date

The provision is effective for wages paid or incurred to a qualified individual who begins work for an employer on or after July 1, 1999, and before January 1, 2002.

Current California Law

California does not conform to this federal credit. However, the local agency military base recovery area (LAMBRA) and enterprise zone hiring credits must be reduce by any allowable federal WOTC or Welfare-To-Work Tax Credit.

Impact on California Revenue

Not applicable.

Section Section Title

506 Extend Exclusion for Employer-Provided Educational Assistance

Background

Educational expenses paid by an employer for the employer's employees are generally deductible to the employer.

Employer-paid educational expenses are excludable from the gross income and wages of an employee if provided under a section 127 educational assistance plan or if the expenses qualify as a working condition fringe benefit under section 132. Section 127 provides an exclusion of \$5,250 annually for

employer-provided educational assistance. The exclusion expired with respect to graduate courses June 30, 1996. With respect to undergraduate courses, the exclusion for employer-provided educational assistance expires with respect to courses beginning on or after June 1, 2000.

In order for the exclusion to apply, certain requirements must be satisfied. The educational assistance must be provided pursuant to a separate written plan of the employer. The educational assistance program must not discriminate in favor of highly compensated employees. In addition, not more than 5% of the amounts paid or incurred by the employer during the year for educational assistance under a qualified educational assistance plan can be provided for the class of individuals consisting of more than 5% owners of the employer (and their spouses and dependents).

Educational expenses that do not qualify for the section 127 exclusion may be excludable from income as a working condition fringe benefit. In general, education qualifies as a working condition fringe benefit if the employee could have deducted the education expenses under section 162 if the employee paid for the education. In general, education expenses are deductible by an individual under section 162 if the education (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, applicable law or regulations imposed as a condition of continued employment. However, education expenses are generally not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business. In the case of an employee, education expenses (if not reimbursed by the employer) may be claimed as an itemized deduction only if such expenses, along with other miscellaneous deductions, exceed 2% of the taxpayer's AGI. The 2% floor limitation is disregarded in determining whether an item is excludable as a working condition fringe benefit.

New Federal Law (IRC Section 127)

The Act provides that the present-law exclusion for employer-provided educational assistance is extended through December 31, 2001.

Effective Date

The provision is effective with respect to courses beginning after May 31, 2000, and before January 1, 2002.

Current California Law (R&TC Section 17151)

California law conforms to federal law in respect to education assistance plans. However, California's exclusion of up to \$5,250 a year for education assistance is permanent.

Impact on California Revenue

Not applicable. California's exclusion is permanent.

Section Section Title

507 Extend and Modify Tax Credit for Electricity Produced by Wind and

Closed-Loop Biomass Facilities

Background

An income tax credit is allowed for the production of electricity from either qualified wind energy or qualified "closed-loop" biomass facilities (Section 45.) The credit applies to electricity produced by a qualified wind energy facility placed in service after December 31, 1993, and before July 1, 1999, and to electricity produced by a qualified closed-loop biomass facility placed in service after December 31, 1992, and before July 1, 1999. The credit is allowable for production during the 10-year period after a facility is originally placed in service.

Closed-loop biomass is the use of plant matter, where the plants are grown for the sole purpose of being used to generate electricity. It does not include the use of waste materials (including, but not limited to, scrap wood, manure, and municipal or agricultural waste). The credit also is not available to taxpayers who use standing timber to produce electricity. In order to claim the credit, a taxpayer must own the facility and sell the electricity produced by the facility to an unrelated party.

New Federal Law (IRC Section 45)

The Act extends the present-law tax credit for electricity produced by wind and closed-loop biomass for facilities placed in service after June 30, 1999, and before January 1, 2001. The Act also modifies the tax credit to include electricity produced from poultry litter, for facilities placed in service after December 31, 1999, and before January 1, 2001.

Current California Law

California does not have any comparable credit. Between January 1, 1990, and January 1, 1993, California provided a credit for the commercial production of electricity from solar and wind energy.

Impact on California Revenue

Not applicable.

Section Section Title

508 Extend Duty-Free Treatment Under Generalized System of Preferences

Background

Title V of the Trade Act of 1974, as amended, grants authority to the President to provide duty-free treatment on imports of eligible articles from

designated beneficiary developing countries (BDCs), subject to certain conditions and limitations. To qualify for the generalized system of preferences (GSP) privileges, each beneficiary country is subject to various mandatory and discretionary eligibility criteria. Import sensitive products are ineligible for GSP. Section 505(a) of the Trade Act of 1974, as amended, provides that no duty-free treatment under Title V shall remain in effect after June 30, 1999.

New Federal Law

The Act reauthorizes the GSP program for 27 months, to expire on September 30, 2001. The provision provides for refunds, upon request of the importer, of any duty paid between June 30, 1999 and the effective date of this Act. All entries between the effective date of this Act and September 30, 2001, would enter duty-free.

Current California Law

No comparable provisions are contained in the parts of the Revenue and Taxation Code administered by the Franchise Tax Board (FTB).

Impact on California Revenue

Not applicable as states are preempted from imposing a duty on foreign imports.

Section Section Title

509 Extend Authority to Issue Qualified Zone Academy Bonds

Background

Tax-Exempt Bonds

Interest on state and local governmental bonds generally is excluded from gross income for federal income tax purposes if the proceeds of the bonds are used to finance direct activities of these governmental units, including the financing of public schools (section 103).

Qualified Zone Academy Bonds

As an alternative to traditional tax-exempt bonds, certain states and local governments are given the authority to issue "qualified zone academy bonds." A total of \$400 million of qualified zone academy bonds is authorized to be issued in each of calendar years 1998 and 1999. The \$400 million aggregate bond cap is allocated each year to the States according to their respective populations of individuals below the poverty line. Each state, in turn, allocates the credit to qualified zone academies within such state. A state may carry over any unused allocation into subsequent years.

Certain financial institutions that hold qualified zone academy bonds are entitled to a nonrefundable tax credit in an amount equal to a credit rate multiplied by the face amount of the bond (section 1397E). A taxpayer holding a qualified zone academy bond on the credit allowance date is entitled to a credit. The credit is includable in gross income (as if it were a taxable interest payment on the bond) and may be claimed against regular income tax and AMT liability.

The Treasury Department sets the credit rate at a rate estimated to allow issuance of qualified zone academy bonds without discount and without interest cost to the issuer. The maximum term of the bond is determined by the Treasury Department, so that the present value of the obligation to repay the bond is 50% of the face value of the bond.

"Qualified zone academy bonds" (QZAB) are defined as any bond issued by a state or local government, provided that (1) at least 95% of the proceeds are used for the purpose of renovating, providing equipment to, developing course materials for use at, or training teachers and other school personnel in a "qualified zone academy" and (2) private entities have promised to contribute to the qualified zone academy certain equipment, technical assistance or training, employee services, or other property or services with a value equal to at least 10% of the bond proceeds.

A school is a "qualified zone academy" if (1) the school is a public school that provides education and training below the college level, (2) the school operates a special academic program in cooperation with businesses to enhance the academic curriculum and increase graduation and employment rates, and (3) either (a) the school is located in one of the 31 designated empowerment zones or one of the 95 enterprise communities designated under Code section 1391, or (b) it is reasonably expected that at least 35% of the students at the school will be eligible for free or reduced-cost lunches under the school lunch program established under the National School Lunch Act

New Federal Law (IRC Section 1397E)

The Act authorizes up to \$400 million of qualified zone academy bonds to be issued in each of calendar years 2000 and 2001. Unusued QZAB authority arising in 1998 and 1999 may be carried forward by the state or local government entity to which it is (or was) allocated for up to three years after the year in which the authority originally arose. Unused QZAB authority arising in 2000 and 2001 may be carried forward for two years after the year in which it arises. Each issuer is deemed to have used the oldest QZAB authority, which has been allocated to it first when new bonds are issued.

Effective Date

This provision is effective on the date of enactment.

Current California Law (R&T Section 17133 and 24272)

The Personal Income Tax Law (PITL) specifically does not conform to federal law regarding private activity bonds. The California Constitution provides an exemption from income taxation for all interest from bonds issued by this state or a local government of this state. Federal law, other than the IRC, prohibits state taxation of interest on federal bonds, if the interest on state obligations is exempt from tax. Taxpayers subject to the corporate franchise tax must report as income all interest received. Interest received from federal obligations and California obligations or obligations of its political subdivision generally is excluded from income subject to the corporation and personal income tax.

Impact on California Revenue

Not applicable.

Section Section Title

510 Extend the Tax Credit for First-Time D.C. Homebuyers

Background

First-time homebuyers of a principal residence in the District of Columbia are eligible for a nonrefundable tax credit of up to \$5,000 of the amount of the purchase price. The \$5,000 maximum credit applies both to individuals and married couples. Married individuals filing separately can claim a maximum credit of \$2,500 each. The credit phases out for individual taxpayers with adjusted gross income between \$70,000 and \$90,000 (\$110,000 \$130,000 for joint filers). For purposes of eligibility, "first-time homebuyer" means any individual if such individual did not have a present ownership interest in a principal residence in the District of Columbia in the one year period ending on the date of the purchase of the residence to which the credit applies.

The credit is scheduled to expire for residences purchased after December 31, 2000.

New Federal Law (IRC Section 1400(c))

The Act provides for a one-year extension of the tax credit for first-time D.C. homebuyers, so that it applies to residences purchased on or before December 31, 2001.

Effective Date

The provision is effective for residences purchased after December 31, 2000 and before January 1, 2002.

Current California Law

California has no comparable credit.

Impact on California Revenue

Not applicable.

Section Section Title

511 Extend Expensing of Environmental Remediation Expenditures

Background

Taxpayers can elect to treat certain environmental remediation expenditures that would otherwise be chargeable to capital account as deductible in the year paid or incurred (section 198). The deduction applies for both regular and alternative minimum tax purposes. The expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site. A "qualified contaminated site" generally is any property that (1) is held for use in a trade or business, for the production of income, or as inventory; (2) is certified by the appropriate state environmental agency to be located within a targeted area; and (3) contains (or potentially contains) a hazardous substance (so-called "brownfields").

Targeted areas are defined as: (1) empowerment zones and enterprise communities as designated under present law; (2) sites announced before February, 1997, as being subject to one of the 76 Environmental Protection Agency (EPA) Brownfields Pilots; (3) any population census tract with a poverty rate of 20% or more; and (4) certain industrial and commercial areas that are adjacent to tracts described in (3) above. However, sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 cannot qualify as targeted areas. Eligible expenditures are those paid or incurred before January 1, 2001.

New Federal Law (IRC Section 198)

The Act extends present-law expiration date for section 198 to include those expenditures paid or incurred before January 1, 2002.

Effective Date

The provision to extend the expiration date is effective upon the date of enactment.

Current California Law (R&TC Section 17279.4 & 24369.4)

California is in conformity with federal law as it relates to environmental remediation expenditures; however, as under prior federal law, the provision applies only to expenditures paid or incurred before January 1, 2001. In addition an election to deduct remediation expenditures for federal purposes is applicable for California purposes. No separate election is allowed.

Impact on California Revenue

The revenue impact of this provision is:

Estimated Revenue Impact of Section 511					
Expenditures Paid	or Incurred After Ja	nuary 1, 2001 and			
Before January 1, 2002					
(\$In Millions)					
2000-01	2001-02	2002-03			
-\$1	-\$2	Minor Loss*			

^{*} Loss less than \$500,000

The revenue is based on previous estimates related to the expensing of remediation expenditures.

Section Section Title

512 Temporary Increase in Amount of Rum Excise Tax

Background

A \$13.50 per proof gallon (a proof gallon is a liquid gallon consisting of 50% alcohol) excise tax is imposed on distilled spirits produced in or imported (or brought) into the United States. The excise tax does not apply to distilled spirits that are exported from the United States or to distilled spirits that are consumed in U.S. possessions (e.g., Puerto Rico and the Virgin Islands).

The Internal Revenue Code provides for coverover (payment) to Puerto Rico and the Virgin Islands of \$10.50 per proof gallon of the excise tax imposed on rum imported (or brought) into the United States (without regard to the country of origin). During the five-year period ending on September 30, 1998, the amount covered over was \$11.30 per proof gallon. This temporary increase was enacted in 1993 as transitional relief accompanying a reduction in certain tax benefits for corporations operating in Puerto Rico and the Virgin Islands.

Amounts covered over to Puerto Rico and the Virgin Islands are deposited into the treasuries of the two possessions for use as those possessions determine.

New Federal Law

The Act reinstates the rum excise tax coverover at a rate of \$13.25 per proof gallon during the period from July 1, 1999, through December 31, 2001. The Act includes a special rule for payment of the \$2.75 per proof gallon increase in the coverover rate for Puerto Rico and the Virgin Islands. The special rule applies to payments that otherwise would be made in Fiscal Year 2000.

Effective Date

This provision is effective on July 1, 1999.

Current California Law

California excise taxes are administered by the BOE.

Impact on California Revenue

Defer to the BOE.

Section Section Title

Prohibit Disclosure of Advance Pricing Agreements

Background

Under section 6103, returns and return information are confidential and cannot be disclosed unless authorized by the Internal Revenue Code. The Code defines return information broadly. Return information includes:

- a taxpayer's identity, the nature, source or amount of income, payments, receipts, deductions, exemptions, credits, assets, liabilities, net worth, tax liability, tax withheld, deficiencies, overassessments, or tax payments;
- whether the taxpayer's return was, is being, or will be examined or subject to other investigation or processing;
- or any other data, received by, recorded by, prepared by, furnished to, or collected by the Secretary with respect to a return or with respect to the determination of the existence, or possible existence, of liability (or the amount thereof) of any person under this title for any tax, penalty, interest, fine, forfeiture, or other imposition, or offense.

With certain exceptions, section 6110 makes the text of any written determination the IRS issues available for public inspection. A written determination is any ruling, determination letter, technical advice

memorandum, or Chief Counsel advice. Once the IRS makes the written determination publicly available, the background file documents associated with such written determination are available for public inspection upon written request. The Code defines "background file documents" as any written material submitted in support of the request. Background file documents also include any communications between the IRS and persons outside the IRS concerning such written determination that occur before the IRS issues the determination.

Before making them available for public inspection, section 6110 requires the IRS to delete specific categories of sensitive information from the written determination and background file documents. It also provides judicial and administrative procedures to resolve disputes over the scope of the information the IRS will disclose. In addition, Congress has also wholly exempted certain matters from section 6110's public disclosure requirements. Any part of a written determination or background file that is not disclosed under section 6110 constitutes "return information." The term "return information" means any part of any written determination or any background file document relating to such written determination (as such terms are defined in section 6110(b)) which is not open to public inspection under section 6110.

The Freedom of Information Act (FOIA) lists categories of information that a federal agency must make available for public inspection. The FOIA establishes a presumption that agency records are accessible to the public; however, it also provides nine exemptions from public disclosure. One exemption is for matters specifically exempted from disclosure by a statute other than the FOIA if the exempting statute meets certain requirements. Section 6103 qualifies as an exempting statute under this FOIA provision. Thus, returns and return information that section 6103 deems confidential are exempt from disclosure under the FOIA.

The Advanced Pricing Agreement (APA) program is an alternative dispute resolution program conducted by the IRS, which resolves international transfer pricing issues prior to the filing of the corporate tax return. Transfer pricing issues involve determining the correct amount of sales and purchases between related parties. The IRS derives some of its authority to conduct transfer pricing audits from IRC section 482 (so called "section 482 audits").

Section 6110 is the exclusive means for the public to view IRS written determinations. If Section 6110 covers the written determination, the public cannot use the FOIA to obtain that determination.

An APA is an advance agreement establishing an approved transfer pricing methodology entered into among the taxpayer, the IRS, and a foreign tax authority. The IRS and the foreign tax authority generally agree to accept the results of such approved methodology. Alternatively, an APA also may be negotiated between just the taxpayer and the IRS; such an APA establishes an approved transfer pricing methodology for U.S. tax purposes. The APA program focuses on identifying the appropriate transfer pricing methodology; it does

not determine a taxpayer's tax liability. Taxpayers voluntarily participate in the program.

To resolve the transfer pricing issues, the taxpayer submits detailed and confidential financial information, business plans and projections to the IRS for consideration. Resolution involves an extensive analysis of the taxpayer's functions and risks. Since its inception in 1991, the APA program has resolved more than 180 APAs, and approximately 195 APA requests are pending.

Currently, pending in the U.S. District Court for the District of Columbia are three consolidated lawsuits asserting that APAs are subject to public disclosure under either section 6110 or the FOIA. Prior to this litigation and since the inception of the APA program, the IRS held the position that APAs were confidential return information protected from disclosure by section 6103. The IRS contended that information received or generated as part of the APA process pertains to a taxpayer's liability and therefore was return information as defined in section 6103(b)(2)(A). Thus, the information was subject to section 6103's restrictions on the dissemination of returns and return information. Rev. Proc. 91 22, 1991 1 C.B. 526,534 and Rev. Proc. 96-53, Section 12 1996-2 C.B. 375, 386. On January 11, 1999, the IRS conceded that APAs are "rulings" and therefore are "written determinations" for purposes of section 6110.

Although the court has not yet issued a ruling in the case, the IRS announced its plan to publicly release both existing and future APAs. The IRS then transmitted existing APAs to the respective taxpayers with proposed deletions. It has received comments from some of the affected taxpayers. Where appropriate, foreign tax authorities have also received copies of the relevant APAs for comment on the proposed deletions. No APAs have yet been released to the public.

Some taxpayers assert that the IRS erred in adopting the position that APAs are subject to section 6110 public disclosure. Several have sought to participate as *amici* in the lawsuit to block the release of APAs. They are concerned that release under section 6110 could expose them to expensive litigation to defend the deletion of the confidential information from their APAs. They are also concerned that the section 6110 procedures are insufficient to protect the confidentiality of their trade secrets and other financial and commercial information.

New Federal Law (IRC Section 6103)

The Act amends section 6103 to provide that APAs and related background information are confidential return information under section 6103. Related background information is meant to include: the request for an APA, any material submitted in support of the request, and any communication (written or otherwise) prepared or received by the Secretary in connection with an APA, regardless of when such communication is prepared or received. Protection is not limited to agreements actually executed; it includes

material received and generated in the APA process that does not result in an executed agreement.

Further, APAs and related background information are not "written determinations" as that term is defined in section 6110. Therefore, the public inspection requirements of section 6110 do not apply to APAs and related background information. A document's incorporation in a background file, however, is not intended to be grounds for not disclosing an otherwise disclosable document from a source other than a background file.

The provision requires that the Treasury Department prepare and publish an annual report on the status of APAs. The annual report is to contain the following information:

- Information about the structure, composition, and operation of the APA program office;
- A copy of each current model APA;
- Statistics regarding the amount of time to complete new and renewal APAs;
- The number of APA applications filed during such year;
- The number of APAs executed to date and for the year;
- The number of APA renewals issued to date and for the year;
- The number of pending APA requests;
- The number of pending APA renewals;
- The number of APAs executed and pending (including renewals and renewal requests) that are unilateral, bilateral and multilateral, respectively;
- The number of APAs revoked or canceled, and the number of withdrawals from the APA program, to date and for the year;
- The number of finalized new APAs and renewals by industry;
- General descriptions of:
 - the nature of the relationships between the related organizations, trades, or businesses covered by APAs;
 - the related organizations, trades, or businesses whose prices or results are tested to determine compliance with the transfer pricing methodology prescribed in the APA;
 - the covered transactions and the functions performed and risks assumed by the related organizations, trades or businesses involved;
 - methodologies used to evaluate tested parties and transactions and the circumstances leading to the use of those methodologies;
 - critical assumptions;
 - sources of comparables;
 - comparable selection criteria and the rationale used in determining such criteria;
 - the nature of adjustments to comparables and/or tested parties;
 - the nature of any range agreed to, including information such as whether no range was used and why, whether an inter-quartile range was used, or whether there was a statistical narrowing of the comparables;
 - adjustment mechanisms provided to rectify results that fall outside of the agreed upon APA range;

- the various term lengths for APAs, including rollback years, and the number of APAs with each such term length;
- the nature of documentation required; and
- approaches for sharing of currency or other risks.

In addition, the Act requires the IRS to describe, in each annual report, its efforts to ensure compliance with existing APA agreements. The first report is to cover the period January 1, 1991, through the calendar year including the date of enactment of this provision. The Treasury Department cannot include any information in the report which would have been deleted under section 6110(c) if the report were a written determination as defined in section 6110. Additionally, the report cannot include any information which can be associated with or otherwise identify, directly or indirectly, a particular taxpayer. The Secretary is expected to obtain input from taxpayers to ensure proper protection of taxpayer information and, if necessary, utilize its regulatory authority to implement appropriate processes for obtaining this input. For purposes of section 6103, the report requirement is treated as part of Title 26.

While the provision statutorily requires an annual report, it is not intended to discourage the Treasury Department from issuing other forms of guidance, such as regulations or revenue rulings, consistent with the confidentiality provisions of the Code.

Effective Date

The provision is effective on the date of enactment; accordingly, no APAs, regardless of whether executed before or after enactment, or related background file documents, can be released to the public after the date of enactment. It requires the Treasury Department to publish the first annual report no later than March 30, 2000.

Current California Law

The FTB does not enter into APAs with taxpayers and is not bound by a federal agreement. However, for taxpayers who make waters-edge elections, there is a statutory presumption that federal section 482 determinations are correct and that no further California adjustments are necessary. FTB applies a similar presumption to pricing methods approved in a federal APA. Generally, APAs are not an issue for taxpayers not making a waters-edge election. Most of these taxpayers, where transfer pricing would be an issue, are unitary and file combine reports (which makes transfer pricing issues moot).

Impact on California Revenue

Not applicable.

Section Section Title

522 Authority to Postpone Certain Tax-Related Deadlines Due to Year 2000 Failures

Background

No specific provisions prior to the passage of the Work Improvement Act would have permitted the Secretary of the Treasury to postpone tax-related deadlines by reason of Year 2000 (also known as Y2K) failures. The Secretary is, however, permitted to postpone tax-related deadlines for other reasons. For example, the Secretary may specify that certain deadlines are postponed for a period of up to 90 days in the case of a taxpayer determined to be affected by a Presidentially declared disaster. The deadlines that may be postponed are the same as are postponed by reason of service in a combat zone. The provision does not apply for purposes of determining interest on any overpayment or underpayment. The suspension of time applies to the following acts:

- (1) filing any return of income, estate, or gift tax (except employment and withholding taxes);
- (2) payment of any income, estate, or gift tax (except employment and withholding taxes);
- (3) filing a petition with the Tax Court for a redetermination of deficiency, or for review of a decision rendered by the Tax Court;
- (4) allowance of a credit or refund of any tax;
- (5) filing a claim for credit or refund of any tax;
- (6) bringing suit upon any such claim for credit or refund;
- (7) assessment of any tax;
- (8) giving or making any notice or demand for payment of any tax, or with respect to any liability to the United States in respect of any tax;
- (9) collection of the amount of any liability in respect of any tax;
- (10) bringing suit by the United States in respect of any liability in respect of any tax; and
- (11) any other act required or permitted under the internal revenue laws specified in regulations prescribed under section 7508 by the Secretary.

New Federal Law

The Act permits the Secretary to postpone, on a taxpayer-by-taxpayer basis, certain tax-related deadlines for a period of up to 90 days in the case of a taxpayer that the Secretary determines to have been affected by an actual Y2K related failure. In order to be eligible for relief, taxpayers must have made good faith, reasonable efforts to avoid any Y2K related failures. The relief will be similar to that granted under the Presidentially declared disaster and combat zone provisions, except that employment and withholding taxes also are eligible for relief. The relief will permit the abatement of both penalties and interest.

Effective Date

The provision is effective on December 17, 1999. Current California Law

California law does not contain any provisions relating to Y2K failures. California is in conformity with federal law as it relates to extensions of time in Presidentially declared disaster areas. California law also provides the same relief in Governor declared disaster areas.

Impact on California Revenue

The impact for conforming to this provision would result in a one-time negligible reduction in penalties.

Section Section Title

523 Add Certain Vaccines Against Streptococcus Pneumoniae to the List of Taxable Vaccines

Background

A manufacturer's excise tax is imposed at the rate of 75 cents per dose (section 4131) on the following vaccines recommended for routine administration to children: diphtheria, pertussis, tetanus, measles, mumps, rubella, polio, HIB (haemophilus influenza type B), hepatitis B, varicella (chicken pox), and rotavirus gastroenteritis. The tax applied to any vaccine that is a combination of vaccine components equals 75 cents times the number of components in the combined vaccine. Amounts equal to net revenues from this excise tax are deposited in the Vaccine Injury Compensation Trust Fund (Vaccine Trust Fund) to finance compensation awards under the Federal Vaccine Injury Compensation Program for individuals who suffer certain injuries following administration of the taxable vaccines. This program provides a substitute federal, "no fault" insurance system for the state-law tort and private liability insurance systems otherwise applicable to vaccine manufacturers and physicians. All persons immunized after September 30, 1988, with covered vaccines must pursue compensation under this federal program before bringing civil tort actions under state law.

New Federal Law (IRC Section 4131 and 4132)

The Act adds any conjugate vaccine against streptococcus pneumoniae to the list of taxable vaccines. In addition, the provision changes the effective date enacted in Public Law 105-277 and certain other conforming amendments to expenditure purposes to enable certain payments to be made from the Trust Fund.

The provision also directs the General Accounting Office (GAO) to report to the House Committee on Ways and Means and the Senate Committee on Finance on

the operation and management of expenditures from the Vaccine Trust Fund and to advise the Committees on the adequacy of the Vaccine Trust Fund to meet future claims under the Federal Vaccine Injury Compensation Program. The GAO is directed to report its findings to the House Committee on Ways and Means and the Senate Committee on Finance not later than January 31, 2000.

Effective Date

The provision is effective for vaccine sales beginning on December 18, 1999. No floor stocks tax is to be collected for amounts held for sale on that date.

Current California Law

No comparable provisions are contained in parts of the Revenue and Taxation Code administered by the FTB.

Impact on California Revenue

Defer to the BOE.

Section Section Title

Delay Requirement That Registered Motor Fuels Terminals Offer Dyed Fuel as a Condition of Registration

Background

Excise taxes are imposed on highway motor fuels, including gasoline, diesel fuel, and kerosene, to finance the Highway Trust Fund programs. Subject to limited exceptions, these taxes are imposed on all such fuels when they are removed from registered pipeline or barge terminal facilities, with any tax-exemptions being accomplished by means of refunds to consumers of the fuel. One such exception allows removal of diesel fuel without payment of tax if the fuel is destined for a nontaxable use (e.g., use as heating oil) and is indelibly dyed.

Terminal facilities are not permitted to receive and store non-tax-paid motor fuels unless they are registered with the Internal Revenue Service. Under present law, a prerequisite to registration is that if the terminal offers for sale diesel fuel, it must offer both dyed and undyed diesel fuel. Similarly, if the terminal offers for sale kerosene, it must offer both dyed and undyed kerosene. This "dyed-fuel mandate" was enacted in 1997, to be effective on July 1, 1998. Subsequently, the effective date was delayed until July 1, 2000.

New Federal Law (IRC Section 4121)

The Act delays the effective date of the dyed-fuel mandate for an additional 18 months, through December 31, 2001. No other changes are made to the present highway motor fuels excise tax rules.

Current California Law

California fuel taxes are administered by the BOE.

Impact on California Revenue

Defer to the BOE.

Section Section Title

Provide That Federal Production Payments to Farmers are Taxable in the Year Received

Background

A taxpayer generally is required to include an item in income no later than the time of its actual or constructive receipt, unless such amount properly is accounted for in a different period under the taxpayer's method of accounting. If a taxpayer has an unrestricted right to demand the payment of an amount, the taxpayer is in constructive receipt of that amount regardless of whether the taxpayer makes the demand and actually receives the payment.

The Federal Agriculture Improvement and Reform Act of 1996 (the FAIR Act) provides for production flexibility contracts between certain eligible owners and producers and the Secretary of Agriculture. These contracts generally cover crop years from 1996 through 2002. Annual payments are made under such contracts at specific times during the federal government's fiscal year. Section 112(d)(2) of the FAIR Act provides that one-half of each annual payment is to be made on either December 15 or January 15 of the fiscal year, at the option of the recipient. The remaining one-half of the annual payment must be made no later than September 30 of the fiscal year. The Emergency Farm Financial Relief Act of 1998 added section 112(d)(3) to the FAIR Act, which provides that all payments for fiscal year 1999 are to be paid at such time or times during fiscal year 1999 as the recipient may specify. Thus, the one-half of the annual amount that would otherwise be required to be paid no later than September 30, 1999, can be specified for payment in calendar year 1998.

These options potentially would have resulted in the constructive receipt (and thus inclusion in income) of the payments to which they relate at the time they could have been exercised, regardless of whether they were in fact exercised. However, section 2012 of the Tax and Trade Relief Extension Act of 1998 provided that the time a production flexibility contract payment under

the FAIR Act properly is includible in income is to be determined without regard to either option, effective for production flexibility contract payments made under the FAIR Act in taxable years ending after December 31, 1995.

New Federal Law

The Act provides that any unexercised option to accelerate the receipt of any payment under a production flexibility contract payable under the FAIR Act, as in effect on the date of enactment of the provision, is disregarded in determining the taxable year in which such payment is properly included in gross income. Options to accelerate payments that are enacted in the future are covered by this rule, providing the payment to which they relate is mandated by the FAIR Act as in effect on the date of enactment of this Act. The provision does not delay the inclusion of any amount in gross income beyond the taxable period in which the amount is received.

Effective Date

The provision is effective on December 17, 1999.

Current California Law

California law follows federal law as it read on January 1, 1998, in regards to the tax accounting concept of "constructive receipt." Therefore, the time a production flexibility contract payment received under the FAIR Act is properly includible in income would be determined by taking into account the options granted under the FAIR Act.

Impact on California Revenue

As under federal law, this accounting option timing issue would have a negligible impact on state income tax revenue in any given year.

Section Section Title

531 Modification of Individual Estimated Tax Safe Harbor

Background

Under prior federal law, an individual taxpayer generally is subject to an addition to tax for any underpayment of estimated tax. An individual generally does not have an underpayment of estimated tax if he or she makes timely estimated tax payments at least equal to: (1) 90% of the tax shown on the current year's return or (2) 100% of the prior year's tax. For taxpayers with a prior year's AGI above \$150,000, \$75,000 for married taxpayers filing separately, however, the rule (item 2 above) that allows payment of 100% of prior year's tax is modified. Those married filing joint taxpayers with AGI above \$150,000 (\$75,000 for married taxpayers filing separate) generally must

make estimated payments based on either (1) 90 % of the tax shown on the current year's return or (2) 110% of the prior year's tax.

For taxpayers with a prior year's AGI above \$150,000, the prior year's tax safe harbor is modified for estimated tax payments made for taxable years through 2002. For such taxpayers making estimated tax payments based on prior year's tax, payments must be made based on 105% of prior year's tax for taxable years beginning in 1999, 106% of prior year's tax for taxable years beginning in 2000 and 2001, and 112% of prior year's tax for taxable years beginning in 2002.

New Federal Law (IRC Section 6654)

The Act provides that taxpayers with prior year's AGI above \$150,000 who make estimated tax payments based on prior year's tax must do so based on 108.6% of prior year's tax for estimated tax payments made for taxable year 2000. Taxpayers with prior year's AGI above \$150,000 who make estimated tax payments based on prior year's tax must do so based on 110% of prior year's tax for estimated tax payments made for taxable year 2001. The modified safe harbor percentage is not changed for estimated tax payments made for any taxable years other than 2000 and 2001.

Effective Date

The provision is effective for estimated tax payments made for taxable years beginning after December 31, 1999, and before January 1, 2002.

Current California Law (R&TC Section 19136-19136.6)

Current California law conforms, in general, with federal rules relating to the payment of estimated tax by individuals. However, there are several significant differences:

- The "required payment" is based upon 80% of the current year tax instead of 90%.
- The "required payment" does not include alternative minimum tax.
- Estimated payments are required, unless the tax due for the year is less than \$100.
- No penalty will be assessed if 80% of the current or prior year tax was paid by withholding.
- No penalty will be assessed if 80% of the adjusted gross income consists of wages subject to withholding.
- California requires taxpayers with AGI greater than \$150,000 (\$75,000 if married filing a separate return) to pay 105% of the preceding year's tax liability for 2000 and 112% for 2001.

Impact on California Revenue

Estimated tax payments under the Personal Income Tax Law from this proposal are estimated to create a cash flow loss of -\$1.5 million in fiscal year 2000-2001, a gain of \$3 million in 2001-2002, and a loss of -\$1.5 million for fiscal year 2002-2003.

Estimated cash flow differences for estimated tax payments would depend on the prior year tax liabilities of taxpayers with adjusted gross incomes exceeding \$150,000 (\$75,000 if married filing a separate return) relative to current year projected liabilities.

The above estimates were based on a previous study of high income taxpayers that would be subject to the current state requirement of 105% of prior year for safe harbor purposes. The 2000-2001 impact reflects a decrease (112% to 110%)in estimate payments for 2001 that will be delayed and paid in 2001-2002. The \$3 million gain for the 2001-2002 fiscal year reflects the the prior year's delayed payments and the increase from 110% to 112%. The -\$1.5 loss for the 2002-2003 fiscal year reflects the acceleration of the payments collected in the previous fiscal year.

Section Section Title

Clarify the Tax Treatment of Income and Losses on Derivatives

Background

532

Capital gain treatment applies to gain on the sale or exchange of a capital asset. Capital assets include property other than (1) stock in trade or other types of assets includible in inventory, (2) property used in a trade or business that is real property or property subject to depreciation, (3) accounts or notes receivable acquired in the ordinary course of a trade or business, (4) certain copyrights (or similar property), and (5) U.S. government publications. Gain or loss on such assets generally is treated as ordinary, rather than capital, gain or loss. Certain other Code sections also treat gains or losses as ordinary. For example, the gains or losses of securities dealers or certain electing commodities dealers or electing traders in securities or commodities that are subject to "mark-to-market" accounting are treated as ordinary (section 475).

Treasury regulations (which were finalized in 1994) require ordinary character treatment for most business hedges and provide timing rules requiring that gains or losses on hedging transactions be taken into account in a manner that matches the income or loss from the hedged item or items. The regulations apply to hedges that meet a standard of "risk reduction" with respect to ordinary property held (or to be held) or certain liabilities incurred (or to be incurred) by the taxpayer and that meet certain identification and other requirements (Treas. Reg. section 1.1221-2)

New Federal Law (IRC Section 1221)

The Act adds three categories to the list of assets the gain or loss on which is treated as ordinary (section 1221). The new categories are: (1) commodities derivative financial instruments held by commodities derivatives dealers; (2) hedging transactions; and (3) supplies of a type regularly consumed by the taxpayer in the ordinary course of a taxpayer's trade or business. In defining a hedging transaction, the provision generally codifies the approach taken by the Treasury regulations, but modifies the rules. The "risk reduction" standard of the regulations is broadened to "risk management" with respect to ordinary property held (or to be held) or certain liabilities incurred (or to be incurred). Additionally, the Act provides that the definition of a hedging transaction includes a transaction entered into primarily to manage such other risks as the Secretary may prescribe in regulations.

Effective Date

The provision is effective for any instrument held, acquired, or entered into, any transaction entered into, and supplies held or acquired on or after December 17, 1999.

Current California Law (R&TC Section 18151 & 24990)

California is in conformity with federal law as it relates to taxation of income and losses on derivatives prior to the passage of the Act. However, California's capital gain tax rate is the same as ordinary income.

Impact on California Revenue

Based on the low level of federal estimates for this provision in the Act, conforming to this provision would result in negligible revenue gains of less than \$250,000 annually beginning in 2000-01.

Section Section Title

533 Expand Reporting of Cancellation of Indebtedness Income

Background

Under section 61(a)(12), a taxpayer's gross income includes income from the discharge of indebtedness. Section 6050P requires "applicable entities" to file information returns with the Internal Revenue Service (IRS) regarding any discharge of indebtedness of \$600 or more. The information return must set forth the name, address, and taxpayer identification number of the person whose debt was discharged, the amount of debt discharged, the date on which the debt was discharged, and any other information that the IRS requires to be provided. The information return must be filed in the manner and at the time specified by the IRS. The same information also must be provided to the

person whose debt is discharged by January 31 of the year following the discharge.

"Applicable entities" include: (1) the Federal Deposit Insurance Corporation (FDIC), the Resolution Trust Corporation (RTC), the National Credit Union Administration, and successor or subunit of any of them; (2) any financial institution (as described in section 581 (relating to banks) or section 591(a) (relating to savings institutions)); (3) any credit union; (4) any corporation that is a direct or indirect subsidiary of an entity described in (2) or (3) which, by virtue of being affiliated with such entity, is subject to supervision and examination by a federal or state agency regulating such entities; and (5) an executive, judicial, or legislative agency (as defined in 31 U.S.C. section 3701(a)(4)).

Failures to file correct information returns with the IRS or to furnish statements to taxpayers with respect to these discharges of indebtedness are subject to the same general penalty that is imposed with respect to failures to provide other types of information returns. Accordingly, the penalty for failure to furnish statements to taxpayers is generally \$50 per failure, subject to a maximum of \$100,000 for any calendar year. These penalties are not applicable if the failure is due to reasonable cause and not to willful neglect.

New Federal Law (IRC Section 6050P)

The Act requires information reporting on indebtedness discharged by any organization for which a significant trade or business is the lending of money (such as finance companies and credit card companies regardless of whether affiliated with financial institutions).

Effective Date

The provision is effective with respect to discharges of indebtedness after December 31, 1999.

Current California Law (R&TC Section 18645)

California is in conformity with federal law as it relates to the reporting requirements for cancellation of indebtedness income prior to the passage of the Act.

Impact on California Revenue

Based on the low level of federal estimates for this provision in the Act, conforming to this provision would result in negligible revenue gains of less than \$250,000 annually beginning in 2000-01. The provision would be effective with cancellations of indebtedness occurring after December 31, 1999.

Section Section Title

Limit Conversion of Character of Income from Constructive
Ownership Transactions

Background

The maximum individual income tax rate on ordinary income and short-term capital gain is 39.6%, while the maximum individual income tax rate on long-term capital gain generally is 20%. Long-term capital gain means gain from the sale or exchange of a capital asset held more than one year. For this purpose, gain from the termination of a right with respect to property which would be a capital asset in the hands of the taxpayer is treated as capital gain.

A pass-through entity (such as a partnership) generally is not subject to federal income tax. Rather, each owner includes its share of a pass-through entity's income, gain, loss, deduction or credit in its taxable income. Generally, the character of the item is determined at the entity level and flows through to the owners. Thus, for example, the treatment of an item of income by a partnership as ordinary income, short-term capital gain, or long-term capital gain retains its character when reported by each of the partners. Investors may enter into forward contracts, notional principal contracts, and other similar arrangements with respect to property that provides the investor with the same or similar economic benefits as owning the property directly but with potentially different tax consequences (to the character and timing of any gain).

New Federal Law (IRC Section 1260)

The Act limits the amount of long-term capital gain a taxpayer could recognize from certain derivative contracts ("constructive ownership transactions") with respect to certain financial assets. The amount of long-term capital gain is limited to the amount of such gain the taxpayer would have recognized if the taxpayer held the financial asset directly during the term of the derivative contract. Any gain in excess of this amount is treated as ordinary income. An interest charge is imposed on the amount of gain that is treated as ordinary income. The provision does not alter the tax treatment of the long-term capital gain that is not treated as ordinary income.

A taxpayer is treated as having entered into a constructive ownership transaction if the taxpayer (1) holds a long position under a notional principal contract with respect to the financial asset, (2) enters into a forward contract to acquire the financial asset, (3) is the holder of a call option, and the grantor of a put option, with respect to a financial asset, and the options have substantially equal strike prices and substantially contemporaneous maturity dates, or (4) to the extent provided in regulations, enters into one or more transactions, or acquires one or more other positions, that have substantially the same effect as any of the transactions described. Treasury regulations, when issued, are expected to provide specific standards for determining when other types of financial transactions, like those specified in the provision, have substantially the

same effect of replicating the economic benefits of direct ownership of a financial asset without a significant change in the risk-reward profile with respect to the underlying transaction. It is not expected that leverage in a constructive ownership transaction would change the risk-reward profile with respect to the underlying transaction.

A "financial asset" is defined as (1) any equity interest in a pass-through entity, and (2) to the extent provided in regulations, any debt instrument and any stock in a corporation that is not a pass-through entity. A "pass-through entity" refers to:

- (1) a regulated investment company (RIC),
- (2) a real estate investment trust (REIT),
- (3) a real estate mortgage investment conduit (REMIC),
- (4) an S corporation,
- (5) a partnership,
- (6) a trust,
- (7) a common trust fund,
- (8) a passive foreign investment company (PFC) which includes an investment company that is also a controlled foreign corporation,
- (9) a foreign personal holding company, and
- (10) a foreign investment company.

The amount of recharacterized gain is calculated as the excess of the amount of long-term capital gain the taxpayer would have had absent this provision over the "net underlying long-term capital gain" attributable to the financial asset. The net underlying long-term capital gain is the amount of net capital gain the taxpayer would have realized if it had acquired the financial asset for its fair market value on the date the constructive ownership transaction was opened and sold the financial asset on the date the transaction was closed (only taking into account gains and losses that would have resulted from a deemed ownership of the financial asset). A taxpayer must establish the amount of the net underlying long-term capital gain with clear and convincing evidence; otherwise, the amount is deemed to be zero. To the extent that the economic positions of the taxpayer and the counter party do not equally offset each other, the amount of the net underlying long-term capital gain may be difficult to establish. The long-term capital gains rate on the net underlying long-term capital gain is determined by reference to the individual capital gains rates in section 1(h).

Example 1: On January 1, 2000, Taxpayer enters into a three-year notional principal contract (a constructive ownership transaction) with a securities dealer whereby, on the settlement date, the dealer agrees to pay Taxpayer the amount of any increase in the notional value of an interest in an investment partnership (the financial asset). After three years, the value of the notional principal contract increased by \$200,000, of which \$150,000 is attributable to ordinary income and net short-term capital gain (\$50,000 is attributable to net long-term capital gains). The amount of the net underlying long-term capital gains is \$50,000, and the amount of gain that is recharacterized as ordinary income is \$150,000 (the excess of \$200,000 of long-term gain over the \$50,000 of net underlying long-term capital gain).

An interest charge is imposed on the underpayment of tax for each year that the constructive ownership transaction was open. The interest charge is the amount of interest that would be imposed under section 6601 had the recharacterized gain been included in the taxpayer's gross income during the term of the constructive ownership transaction. The recharacterized gain is treated as having accrued such that the gain in each successive year is equal to the gain in the prior year increased by a constant growth rate during the term of the constructive ownership transaction.

Example 2: Same facts as in example 1, and assume the applicable federal rate on December 31, 2002, is 6%. For purposes of calculating the interest charge, Taxpayer must allocate the \$150,000 of recharacterized ordinary income to the three year-term of the constructive ownership transaction as follows: \$47,116.47 is allocated to year 2000, \$49,943.46 is allocated to year 2001, and \$52,940.07 is allocated to year 2002.

A taxpayer is treated as holding a long position under a notional principal contract with respect to a financial asset if the person (1) has the right to be paid (or receive credit for) all or substantially all of the investment yield (including appreciation) on the financial asset for a specified period, and (2) is obligated to reimburse (or provide credit) for all or substantially all of any decline in the value of the financial asset. A forward contract is a contract to acquire in the future (or provide or receive credit for the future value of) any financial asset.

If the constructive ownership transaction is closed by reason of taking delivery of the underlying financial asset, the taxpayer is treated as having sold the contract, option, or other position that is part of the transaction for its fair market value on the closing date. However, the amount of gain that is recognized as a result of having taken delivery is limited to the amount of gain that is treated as ordinary income by reason of this provision (with appropriate basis adjustments for such gain).

The provision does not apply to any constructive ownership transaction if all of the positions that are part of the transaction are marked to market under the Code or regulations. The Treasury Department is authorized to prescribe regulations as necessary to carry out the purposes of the provision, including to (1) permit taxpayers to mark to market constructive ownership transactions in lieu of the provision, and (2) exclude certain forward contracts that do not convey substantially all of the economic return with respect to a financial asset.

No inference is intended as to the proper treatment of a constructive ownership transaction entered into prior to the effective date of this provision.

Effective Date

The provision applies to transactions entered into on or after July 12, 1999. For this purpose, it is expected that a contract, option or any other

arrangement that is entered into or exercised on or after July 12, 1999, which extends or otherwise modifies the terms of a transaction entered into prior to such date will be treated as a transaction entered into on or after July 12, 1999, unless a party to the transaction other than the taxpayer has, as of July 12, 1999, the exclusive right to extend the terms of the transaction, and the length of such extension does not exceed the first business day following a period of five years from the original termination date under the transaction.

Current California Law

California does not have different tax rates for capital gain and ordinary income. California is generally in conformity with federal law as it relates to the computation of capital gain verses ordinary income.

Impact on California Revenue

The net revenue impact from conforming to this proposal would probably not exceed \$1 million in gains annually.

Federal estimates reflect all provisions dealing with ordinary income recharacterization and are not particularly significant. Potential revenue gains for California would be even less significant given the fact that no differential tax rate exists between ordinary income and capital gain income. The estimated \$1 million revenue gain would primarily reflect limitations on capital loss deductions.

Section Section Title

Treatment of Excess Pension Assets Used for Retiree Health Benefits

Background

Defined benefit pension plan assets generally may not revert to an employer prior to the termination of the plan and the satisfaction of all plan liabilities. A reversion prior to plan termination may constitute a prohibited transaction and may result in disqualification of the plan. Certain limitations and procedural requirements apply to a reversion upon plan termination. Any assets that revert to the employer upon plan termination are includible in the gross income of the employer and subject to an excise tax. The excise tax rate, which may be as high as 50% of the reversion, varies depending upon whether the employer maintains a replacement plan or makes certain benefit increases. Upon plan termination, the accrued benefits of all plan participants are required to be 100% vested.

A pension plan may provide medical benefits to retired employees through a section 401(h) account that is a part of such plan. A qualified transfer of excess assets of a defined benefit pension plan (other than a multi-employer

plan) into a section 401(h) account that is a part of such plan does not result in plan disqualification and is not treated as a reversion to the employer or a prohibited transaction. Therefore, the transferred assets are not includible in the gross income of the employer and are not subject to the excise tax on reversions.

Qualified transfers are subject to amount and frequency limitations, use requirements, deduction limitations, vesting requirements, and minimum benefit requirements. Excess assets transferred in a qualified transfer may not exceed the amount reasonably estimated to be the amount that the employer will pay out of such account during the taxable year of the transfer for qualified current retiree health liabilities. No more than one qualified transfer with respect to any plan may occur in any taxable year.

The transferred assets (and any income thereon) must be used to pay qualified current retiree health liabilities (either directly or through reimbursement) for the taxable year of the transfer. Transferred amounts generally must benefit all pension plan participants, other than key employees, who are entitled upon retirement to receive retiree medical benefits through the section 401(h) account. Retiree health benefits of key employees may not be paid (directly or indirectly) out of transferred assets. Amounts not used to pay qualified current retiree health liabilities for the taxable year of the transfer are to be returned at the end of the taxable year to the general assets of the plan. These amounts are not includible in the gross income of the employer, but are treated as an employer reversion and are subject to a 20% excise tax.

No deduction is allowed for (1) a qualified transfer of excess pension assets into a section 401(h) account, (2) the payment of qualified current retiree health liabilities out of transferred assets (and any income thereon) or (3) a return of amounts not used to pay qualified current retiree health liabilities to the general assets of the pension plan.

In order for the transfer to be qualified, accrued retirement benefits under the pension plan generally must be 100% vested as if the plan terminated immediately before the transfer.

The minimum benefit requirement requires each group health plan under which applicable health benefits are provided to provide substantially the same level of applicable health benefits for the taxable year of the transfer and the following four taxable years. The level of benefits that must be maintained is based on benefits provided in the year immediately preceding the taxable year of the transfer. Applicable health benefits are health benefits or coverage that are provided to (1) retirees who, immediately before the transfer, are entitled to receive such benefits upon retirement and who are entitled to pension benefits under the plan and (2) the spouses and dependents of such retirees.

Title I of the Employee Retirement Income Security Act of 1974, as amended (ERISA), provides that plan participants, the Secretaries of Treasury and the Department of Labor, the plan administrator, and each employee organization

representing plan participants must be notified 60 days before a qualified transfer of excess assets to a retiree health benefits account occurs (ERISA section 103(e)). ERISA also provides that a qualified transfer is not a prohibited transaction under ERISA (ERISA section 408(b)(13)) or a prohibited reversion of assets to the employer (ERISA section 403(c)(1)). For purposes of these provisions, a qualified transfer is generally defined as a transfer pursuant to section 420 of the Internal Revenue Code, as in effect on January 1, 1995.

The provision permitting a qualified transfer of excess pension assets to pay qualified current retiree health liabilities expires for taxable years beginning after December 31, 2000.

New Federal Law (IRC Section 420)

The Act extends the present-law provision permitting qualified transfers of excess defined benefit pension plan assets to provide retiree health benefits under a section 401(h) account through December 31, 2005.

In addition, the present-law minimum benefit requirement is replaced by the minimum cost requirement that applied to qualified transfers before December 9, 1994, to section 401(h) accounts. Therefore, each group health plan or arrangement under which applicable health benefits are provided is required to provide a minimum dollar level of retiree health expenditures for the taxable year of the transfer and the following four taxable years. The minimum dollar level is the higher of the applicable employer costs for each of the two taxable years immediately preceding the taxable year of the transfer. The applicable employer cost for a taxable year is determined by dividing the employer's qualified current retiree health liabilities by the number of individuals to whom coverage for applicable health benefits was provided during the taxable year.

The Secretary of the Treasury is directed to prescribe such regulations as may be necessary to prevent an employer who significantly reduces retiree health coverage during the cost maintenance period from being treated as satisfying the minimum cost requirement. In addition, the provision contains a transition rule regarding the minimum cost requirement. Under this rule, an employer must satisfy the minimum benefit requirement with respect to a qualified transfer that occurs after December 17, 1999, during the portion of the cost maintenance period of such transfer that occurs on or before December 17, 1999. For example, suppose an employer (with a calendar year taxable year) made a qualified transfer in 1998. The minimum benefit requirement must be satisfied for calendar years 1998, 1999, 2000, 2001, and 2002. Suppose the employer also makes a qualified transfer in 2000. Then, the employer is required to satisfy the minimum benefit requirement in 2000, 2001, and 2002, and is required to satisfy the minimum cost requirement in 2003 and 2004.

Effective Date

The provision is effective with respect to qualified transfers of excess defined benefit pension plan assets to section 401(h) accounts after December 31, 2000, and before January 1, 2006. The modification of the minimum benefit requirement is effective with respect to transfers after December 17, 1999.

Current California Law

California is in conformity with federal law on qualified transfers of excess defined benefit pension plans as it read on January 1, 1998. However, California does not impose the excise tax on assets that revert to the employer upon termination of the plan.

Impact on California Revenue

Conforming to this federal provision would result in minor baseline revenue gains of less than \$500,000 in 2000-01, and baseline gains of \$1 million each in 2001-02 and 2002-03. The provision would be effective with qualified transfers made in taxable years beginning after December 31, 2000, through December 31, 2005. Revenue gains are the result of payment of health liabilities out of transferred assets rather than employers directly incurring an expense that otherwise would be deductible. Estimates were based on a proration of federal projections developed for the Work Improvement Act of 1999.

Section Section Title

Modify Installment Method and Prohibit Use by Accrual Method Taxpayers

Background

An accrual method taxpayer is generally required to recognize income when all the events have occurred that fix the right to the receipt of the income and the amount of the income can be determined with reasonable accuracy. The installment method of accounting provides an exception to this general principle of income recognition by allowing a taxpayer to defer the recognition of income from the disposition of certain property until payment is received. Sales to customers in the ordinary course of business are not eligible for the installment method, except for sales of property that is used or produced in the trade or business of farming and sales of timeshares and residential lots if an election to pay interest under section 453(1)(2)(B) is made.

A pledge rule provides that if an installment obligation is pledged as security for any indebtedness, the net proceeds of such indebtedness are treated as a payment on the obligation, triggering the recognition of income.

Actual payments received on the installment obligation subsequent to the receipt of the loan proceeds are not taken into account until such subsequent payments exceed the loan proceeds that were treated as payments. The pledge rule does not apply to sales of property used or produced in the trade or business of farming, to sales of timeshares and residential lots where the taxpayer elects to pay interest under section 453(1)(2)(B), or to dispositions where the sales price does not exceed \$150,000.

An additional rule requires the payment of interest on the deferred tax that is attributable to most large installment sales.

New Federal Law (IRC Section 453 & 453A)

The Act generally prohibits the use of the installment method of accounting for dispositions of property that would otherwise be reported for federal income tax purposes using an accrual method of accounting and modifies the installment sale pledge rule to provide that entering into any arrangement that gives the taxpayer the right to satisfy an obligation with an installment note will be treated in the same manner as the direct pledge of the installment note.

The provision does not change present law regarding the availability of the installment method for dispositions of property used or produced in the trade or business of farming. The provision also does not change present law regarding the availability of the installment method for dispositions of timeshares or residential lots if the taxpayer elects to pay interest under section 453(1). The provision does not change the ability of a cash method taxpayer to use the installment method. For example, a cash method individual owns all of the stock of a closely held accrual method corporation. This individual sells his stock for cash, a ten year note, and a percentage of the gross revenues of the company for next ten years. The provision does not change the ability of this individual to use the installment method in reporting the gain on the sale of the stock.

The provision modifies the pledge rule to provide that entering into any arrangement that gives the taxpayer the right to satisfy an obligation with an installment note will be treated in the same manner as the direct pledge of the installment note. For example, a taxpayer disposes of property for an installment note. The disposition is properly reported using the installment method. The taxpayer only recognizes gain as it receives the deferred payment. However, were the taxpayer to pledge the installment note as security for a loan, it would be required to treat the proceeds of such loan as a payment on the installment note and recognize the appropriate amount of gain. Under the provision, the taxpayer would also be required to treat the proceeds of a loan as payment on the installment note to the extent the taxpayer had the right to "put" or repay the loan by transferring the installment note to the taxpayer's creditor. Other arrangements that have a similar effect would be treated in the same manner.

The modification of the pledge rule applies only to installment sales where the pledge rule of present law applies. Accordingly, the provision does not

apply to (1) installment method sales made by a dealer in timeshares and residential lots where the taxpayer elects to pay interest under section 453(1)(2)(B), (2) sales of property used or produced in the trade or business of farming, or (3) dispositions where the sales price does not exceed \$150,000, since such sales are not subject to the pledge rule under present law.

Effective Date

The provision is effective for sales or other dispositions entered into on or after December 17, 1999.

Current California Law

California is in conformity with federal law prior to the passage of the Act as it relates to installment sales.

Impact on California Revenue

The revenue impact from this provision are estimated as follows for dispositions entered into on or after January 1, 2000:

Estimated Revenue Impact						
Enactment	After 3	June 30, 2000				
Fiscal Years						
(In Millions)						
2000-1	2001-2	2002-3				
\$30	\$12	\$8				

The larger impact of the first fiscal year is due to eighteen months of activity rather than twelve. The subsequent years drop-off because of the earlier recognition of income under the proposal.

The revenue impact of this proposal would depend upon the number of individuals who would enter into an arrangement which would satisfy an obligation with an installment note, and the amount of gain recognized.

Revenue estimates above were based on federal projections for this provision in HR 1180, modified to reflect a January 1, 2000, effective date.

Section Section Title

Denial of Charitable Contribution Deduction for Transfers
Associated with Split-Dollar Insurance Arrangements

Background

Under present law, in computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct charitable contributions paid during the taxable year. The amount of the deduction allowable for a taxable year with respect to any charitable contribution depends on the type of property contributed, the type of organization to which the property is contributed, and the income of the taxpayer (sections 170(b) and 170(e)). A charitable contribution is defined to mean a contribution or gift to or for the use of a charitable organization or certain other entities (section 170(c)). The term "contribution or gift" is not defined by statute, but generally is interpreted to mean a voluntary transfer of money or other property without receipt of adequate consideration and with donative intent. If a taxpayer receives or expects to receive a quid pro quo in exchange for a transfer to charity, the taxpayer may be able to deduct the excess of the amount transferred over the fair market value of any benefit received in return, provided the excess payment is made with the intention of making a gift.

In general, no charitable contribution deduction is allowed for a transfer to charity of less than the taxpayer's entire interest (i.e., a partial interest) in any property (section 170(f)(3)). In addition, no deduction is allowed for any contribution of \$250 or more unless the taxpayer obtains a contemporaneous written acknowledgment from the donee organization that includes a description and good faith estimate of the value of any goods or services provided by the donee organization to the taxpayer in consideration, whole or part, for the taxpayer's contribution (section 170(f)(8)).

New Federal Law (IRC Section 501(c)(28))

Deduction Denial

The Act restates present law to provide that no charitable contribution deduction is allowed for purposes of federal tax, for a transfer to or for the use of an organization described in section 170(c) of the Code, if in connection with the transfer (1) the organization directly or indirectly pays, or has previously paid, any premium on any "personal benefit contract" with respect to the transferor, or (2) there is an understanding or expectation that any person will directly or indirectly pay any premium on any "personal benefit contract" with respect to the transferor. It is intended that an organization be considered as indirectly paying premiums if, for example, another person pays premiums on its behalf.

A personal benefit contract with respect to the transferor is any life insurance, annuity, or endowment contract, if any direct or indirect beneficiary under the contract is the transferor, any member of the transferor's family, or any other person (other than a section 170(c)

organization) designated by the transferor. For example, such a beneficiary would include a trust having a direct or indirect beneficiary who is the transferor or any member of the transferor's family, and would include an entity that is controlled by the transferor or any member of the transferor's family. It is intended that a beneficiary under the contract include any beneficiary under any side agreement relating to the contract. If a transferor contributes a life insurance contract to a section 170(c) organization and designates one or more section 170(c) organizations as the sole beneficiaries under the contract, generally, it is not intended that the deduction denial rule under the provision apply. If, however, there is an outstanding loan under the contract upon the transfer of the contract, then the transferor is considered as a beneficiary. The fact that a contract also has other direct or indirect beneficiaries (persons who are not the transferor or a family member, or designated by the transferor) does not prevent it from being a personal benefit contract. The provision is not intended to affect situations in which an organization pays premiums under a legitimate fringe benefit plan for employees.

It is intended that a person be considered as an indirect beneficiary under a contract if, for example, the person receives or will receive any economic benefit as a result of amounts paid under or with respect to the contract. For this purpose, as described below, an indirect beneficiary is not intended to include a person that benefits exclusively under a bona fide charitable gift annuity (within the meaning of section 501(m)).

In the case of a charitable gift annuity, if the charitable organization purchases an annuity contract issued by an insurance company to fund its obligation to pay the charitable gift annuity, a person receiving payments under the charitable gift annuity is not treated as an indirect beneficiary, provided certain requirements are met. The requirements are that (1) the charitable organization possess all of the incidents of ownership (within the meaning of Treas. Reg. section 20.2042 1(c)) under the annuity contract purchased by the charitable organization; (2) the charitable organization be entitled to all the payments under the contract; and (3) the timing and amount of payments under the contract be substantially the same as the timing and amount of payments to each person under the organization's obligation under the charitable gift annuity (as in effect at the time of the transfer to the charitable organization).

Under the provision, an individual's family consists of the individual's grandparents, the grandparents of the individual's spouse, the lineal descendants of such grandparents, and any spouse of such a lineal descendant.

In the case of a charitable gift annuity obligation that is issued under the laws of a state that requires, in order for the charitable gift annuity to be exempt from insurance regulation by that state, that each beneficiary under the charitable gift annuity be named as a beneficiary under an annuity contract issued by an insurance company authorized to transact business in that state, then the foregoing requirements (1) and (2) are treated as if they are met, provided that certain additional requirements are met. The additional requirements are that the state law requirement was in effect on

February 8, 1999, each beneficiary under the charitable gift annuity is a bona fide resident of the state at the time the charitable gift annuity was issued, the only persons entitled to payments under the annuity contract issued by the insurance company are persons entitled to payments under the charitable gift annuity when it was issued, and (as required by clause (iii) of subparagraph (D) of the provision) the timing and amount of payments under the annuity contract to each person are substantially the same as the timing and amount of payments to the person under the charitable gift annuity (as in effect at the time of the transfer to the charitable organization).

In the case of a charitable remainder annuity trust or charitable remainder unitrust (as defined in section 664(d)) that holds a life insurance, endowment or annuity contract issued by an insurance company, a person is not treated as an indirect beneficiary under the contract held by the trust, solely by reason of being a recipient of an annuity or unitrust amount paid by the trust, provided that the trust possesses all of the incidents of ownership under the contract and is entitled to all the payments under such contract. No inference is intended as to the applicability of other provisions of the Code with respect to the acquisition by the trust of a life insurance, endowment or annuity contract, or the appropriateness of such an investment by a charitable remainder trust.

Nothing in the provision is intended to suggest that a life insurance, endowment, or annuity contract would be a personal benefit contract, solely because an individual who is a recipient of an annuity or unitrust amount paid by a charitable remainder annuity trust or charitable remainder unitrust uses such a payment to purchase a life insurance, endowment or annuity contract, and a beneficiary under the contract is the recipient, a member of his or her family, or another person he or she designates

The provision imposes on any organization described in section 170(c) of the Code an excise tax, equal to the amount of the premiums paid by the organization on any life insurance, annuity, or endowment contract, if the premiums are paid in connection with a transfer for which a deduction is not allowable under the deduction denial rule of the provision (without regard to when the transfer to the charitable organization was made). The excise tax does not apply if all of the direct and indirect beneficiaries under the contract (including any related side agreement) are organizations described in section 170(c). Under the provision, payments are treated as made by the organization, if they are made by any other person pursuant to an understanding or expectation of payment. The excise tax is to be applied taking into account rules ordinarily applicable to excise taxes in chapter 41 or 42 of the Code (e.g., statute of limitation rules).

The provision requires that the charitable organization annually report the amount of premiums that is paid during the year and that is subject to the excise tax imposed under the provision, and the name and taxpayer identification number of each beneficiary under the life insurance, annuity or endowment contract to which the premiums relate, as well as other information required by the Secretary of the Treasury. For this purpose, it is intended that a beneficiary include any beneficiary under any side

agreement to which the section 170(c) organization is a party (or of which it is otherwise aware). Penalties applicable to returns required under Code section 6033 apply to returns under this reporting requirement. Returns required under this provision are to be furnished at such time and in such manner as the Secretary shall by forms or regulations require.

The provision provides for the promulgation of regulations necessary or appropriate to carry out the purposes of the provisions, including regulations to prevent the avoidance of the purposes of the provision. For example, it is intended that regulations prevent avoidance of the purposes of the provision by inappropriate or improper reliance on the limited exceptions provided for certain beneficiaries under bona fide charitable gift annuities and for certain noncharitable recipients of an annuity or unitrust amount paid by a charitable remainder trust.

Effective Date

The deduction denial provision applies to transfers after February 8, 1999 (as provided in H.R. 630). The excise tax provision applies to premiums paid after December 17, 1999. The reporting provision applies to premiums paid after February 8, 1999 (determined as if the excise tax imposed under the provision applied to premiums paid after that date).

No inference is intended that a charitable contribution deduction is allowed under present law with respect to a charitable split-dollar insurance arrangement. The provision does not change the rules with respect to fraud or criminal or civil penalties under present law; thus, actions constituting fraud or that are subject to penalties under present law would still constitute fraud or be subject to the penalties after enactment of the provision.

Current California Law (R&TC Section 23701)

California is in conformity with federal law as it relates to charitable contributions of split-dollar insurance prior to the passage of the Act.

Impact on California Revenue

The impact for conforming to this provision would result in a negligible revenue gain.

Section Title Section

538 Distributions by a Partnership to a Corporate Partner of Stock In

Another Corporation

Background

Present law generally provides that no gain or loss is recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation in which it holds 80% of the stock (by vote and value) (section 332). The basis of property received by a corporate distributee in the distribution in complete liquidation of the 80% owned subsidiary is a carryover basis, i.e., the same as the basis in the hands of the subsidiary (provided no gain or loss is recognized by the liquidating corporation with respect to the distributed property) (section 334(b)).

Present law provides two different rules for determining a partner's basis in distributed property, depending on whether or not the distribution is in liquidation of the partner's interest in the partnership. Generally, a substituted basis rule applies to property distributed to a partner in liquidation. Thus, the basis of property distributed in liquidation of a partner's interest is equal to the partner's adjusted basis in its partnership interest (reduced by any money distributed in the same transaction) (section 732(b)).

By contrast, generally, a carryover basis rule applies to property distributed to a partner other than in liquidation of its partnership interest, subject to a cap (section 732(a)). Thus, in a non-liquidating distribution, the distributee partner's basis in the property is equal to the partnership's adjusted basis in the property immediately before the distribution, but not to exceed the partner's adjusted basis in its partnership interest (reduced by any money distributed in the same transaction). In a non-liquidating distribution, the partner's basis in its partnership interest is reduced by the amount of the basis to the distributee partner of the property distributed and is reduced by the amount of any money distributed (section 733).

If corporate stock is distributed by a partnership to a corporate partner with a low basis in its partnership interest, the basis of the stock is reduced in the hands of the partner so that the stock basis equals the distributee partner's adjusted basis in its partnership interest. No comparable reduction is made in the basis of the corporation's assets, however. The effect of reducing the stock basis can be negated by a subsequent liquidation of the corporation under section 332.

New Federal Law (IRC Section 732)

In General.

The Act provides for a basis reduction to assets of a corporation, if stock in that corporation is distributed by a partnership to a corporate partner.

The reduction applies if, after the distribution, the corporate partner controls the distributed corporation.

Amount of the Basis Reduction.

Under the provision, the amount of the reduction in basis of property of the distributed corporation generally equals the amount of the excess of (1) the partnership's adjusted basis in the stock of the distributed corporation immediately before the distribution, over (2) the corporate partner's basis in that stock immediately after the distribution.

The provision limits the amount of the basis reduction in two respects. First, the amount of the basis reduction may not exceed the amount by which (1) the sum of the aggregate adjusted bases of the property and the amount of money of the distributed corporation exceeds (2) the corporate partner's adjusted basis in the stock of the distributed corporation. Thus, for example, if the distributed corporation has cash of \$300 and other property with a basis of \$600 and the corporate partner's basis in the stock of the distributed corporation is \$400, then the amount of the basis reduction could not exceed \$500 (i.e., (\$300+\$600)-\$400 = \$500).

Second, the amount of the basis reduction may not exceed the adjusted basis of the property of the distributed corporation. Thus, the basis of property (other than money) of the distributed corporation could not be reduced below zero under the provision, even though the total amount of the basis reduction would otherwise be greater.

The provision provides that the corporate partner recognizes long-term capital gain to the extent the amount of the basis reduction exceeds the basis of the property (other than money) of the distributed corporation. In addition, the corporate partner's adjusted basis in the stock of the distribution is increased in the same amount. For example, if the amount of the basis reduction were \$400, and the distributed corporation has money of \$200 and other property with an adjusted basis of \$300, then the corporate partner would recognize a \$100 capital gain under the provision. The corporate partner's basis in the stock of the distributed corporation is also increased by \$100 in this example, under the provision.

The basis reduction is allocated among assets of the controlled corporation in accordance with the rules provided under section 732(c).

Partnership Distributions Resulting in Control.

The basis reduction generally applies with respect to a partnership distribution of stock if the corporate partner controls the distributed corporation immediately after the distribution or at any time thereafter. For this purpose, the term control means ownership of stock meeting the requirements of section 1504(a)(2) (generally, an 80% vote and value requirement).

The provision applies to reduce the basis of any property held by the distributed corporation immediately after the distribution, or, if the corporate partner does not control the distributed corporation at that time, then at the time the corporate partner first has such control. The provision does not apply to any distribution if the corporate partner does not have control of the distributed corporation immediately after the distribution and establishes that the distribution was not part of a plan or arrangement to acquire control.

For purposes of the provision, if a corporation acquires (other than in a distribution from a partnership) stock the basis of which is determined (by reason of being distributed from a partnership) in whole or in part by reference to section 732(a)(2) or (b), then the corporation is treated as receiving a distribution of stock from a partnership. For example, if a partnership distributes property other than stock (such as real estate) to a corporate partner, and that corporate partner contributes the real estate to another corporation in a section 351 transaction, then the stock received in the section 351 transaction is not treated as distributed by a partnership, and the basis reduction under this provision does not apply. As another example, if a partnership distributes stock to two corporate partners, neither of which have control of the distributed corporation, and the two corporate partners merge and the survivor obtains control of the distributed corporation, the stock of the distributed corporation that is acquired as a result of the merger is treated as received in a partnership distribution; the basis reduction rule of the provision applies.

In the case of tiered corporations, a special rule provides that if the property held by a distributed corporation is stock in a corporation that the distributed corporation controls, then the provision is applied to reduce the basis of the property of that controlled corporation. The provision is also reapplied to any property of any controlled corporation that is stock in a corporation that it controls. Thus, for example, if stock of a controlled corporation is distributed to a corporate partner, and the controlled corporation has a subsidiary, the amount of the basis reduction allocable to stock of the subsidiary is applied again to reduce the basis of the assets of the subsidiary, under the special rule.

The provision also provides for regulations, including regulations to avoid double counting and to prevent the abuse of the purposes of the provision. It is intended that regulations prevent the avoidance of the purposes of the provision through the use of tiered partnerships.

Effective Date

The provision is effective generally for distributions made after July 14, 1999. However, in the case of a corporation that is a partner in a partnership as of July 14, 1999, the provision is effective for any distribution made (or treated as made) to that partner from that partnership after June 30, 2001. In the case of any such distribution after the date of enactment and before July 1, 2001, the rule of the preceding sentence does not apply unless that partner makes an election to have the rule apply to the

distribution on the partner's return of federal income tax for the taxable year in which the distribution occurs.

No inference is intended that distributions that are not subject to the provision achieve a particular tax result under present law, and no inference is intended that enactment of the provision limits the application of tax rules or principles under present or prior law.

Current California Law (R&TC Section 17851)

California is in conformity with federal law as it relates to partnership distributions of corporate stock prior to the passage of the Act.

Impact on California Revenue

Based on the low level of federal estimates for this provision in the Act, conforming to this provision would result in minor revenue gains of less than \$500,000 annually beginning with 2000-01. It is assumed the provision would be effective for distributions made after July 14, 1999 (except with respect to partnerships in existence on July 14, 1999, the provision is effective July 1, 2001). Revenue estimates were based on a proration of federal projections developed for the Act.

Section Section Title

541- Income and Services Provided by Taxable REITs Subsidiaries

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Background

A real estate investment trust (REIT) is an entity that receives most of its income from passive real-estate related investments and that essentially receives pass-through treatment for income that is distributed to shareholders.

If an electing entity meets the requirements for REIT status, the portion of its income that is distributed to the investors each year generally is taxed to the investors without being subjected to a tax at the REIT level. In general, a REIT must derive its income from passive sources and not engage in any active trade or business.

A REIT must satisfy a number of tests on a year by year basis that relate to the entity's (1) organizational structure; (2) source of income; (3) nature of assets; and (4) distribution of income. Under the source-of-income tests, at least 95% of its gross income generally must be derived from rents from real property, dividends, interest, and certain other passive sources (the "95% test"). In addition, at least 75% of its gross income generally must be from real estate sources, including rents from real property and interest on mortgages secured by real property. For purposes of the 95% and 75% tests,

qualified income includes amounts received from certain "foreclosure property," treated as such for three years after the property is acquired by the REIT in foreclosure after a default (or imminent default) on a lease of such property or on indebtedness which such property secured.

In general, for purposes of the 95% and 75% tests, rents from real property do not include amounts for services to tenants or for managing or operating real property. However, there are some exceptions. Qualified rents include amounts received for services that are "customarily furnished or rendered" in connection with the rental of real property, so long as the services are furnished through an independent contractor from whom the REIT does not derive any income. Amounts received for services that are not "customarily furnished or rendered" are not qualified rents.

An independent contractor is defined as a person who does not own, directly or indirectly, more than 35% of the shares of the REIT. Also, no more than 35% of the total shares of stock of an independent contractor (or of the interests in assets or net profits, if not a corporation) can be owned directly or indirectly by persons owning 35% or more of the interests in the REIT. In addition, a REIT cannot derive any income from an independent contractor.

Rents for certain personal property leased in connection with real property are treated as rents from real property if the adjusted basis of the personal property does not exceed 15% of the aggregate adjusted bases of the real and the personal property.

Rents from real property do not include amounts received from any corporation if the REIT owns 10% or more of the voting power or of the total number of shares of all classes of stock of such corporation. Similarly, in the case of other entities, rents are not qualified if the REIT owns 10% or more of the assets or net profits of such person.

At the close of each quarter of the taxable year, at least 75% of the value of total REIT assets must be represented by real estate assets, cash and cash items, and Government securities. Also, a REIT cannot own securities (other than Government securities and certain real estate assets) in an amount greater than 25% of the value of REIT assets. In addition, it cannot own securities of any one issuer representing more than 5% of the total value of REIT assets or more than 10% of the voting securities of any corporate issuer. Securities for purposes of these rules are defined by reference to the Investment Company Act of 1940 (15 U.S.C. 80a-1 and following. See also Code section 856(c)(5)(F).

Under an exception to the ownership rule, a REIT is permitted to have a wholly owned subsidiary corporation, but the assets and items of income and deduction of such corporation are treated as those of the REIT, and thus can affect the qualification of the REIT under the income and asset tests.

A REIT generally is required to distribute 95% of its income before the end of its taxable year, as deductible dividends paid to shareholders. This rule

is similar to a rule for regulated investment companies (RICs) that requires distribution of 90% of income. Both REITS and RICs can make certain "deficiency dividends" after the close of the taxable year, and have these treated as made before the end of the year. The regulations applicable to REITS state that a distribution will be treated as a "deficiency dividend" (and, thus, as made before the end of the prior taxable year) only to the extent the earnings and profits for that year exceed the amount of distributions actually made during the taxable year.

A REIT that has been or has combined with a C corporation will be disqualified if, as of the end of its taxable year, it has accumulated earnings and profits from a non-REIT year. A similar rule applies to regulated investment companies (RICs). In the case of a REIT, any distribution made in order to comply with this requirement is treated as being first from pre-REIT accumulated earnings and profits. RICs do not have a similar ordering rule.

In the case of a RIC, any distribution made within a specified period after determination that the investment company did not qualify as a RIC for the taxable year will be treated as applying to the RIC for the non-RIC year, "for purposes of applying [the earnings and profits rule that forbids a RIC to have non-RIC earnings and profits] to subsequent taxable years." The REIT rules do not specify any particular separate treatment of distributions made after the end of the taxable year for purposes of the earnings and profits rule. Treasury regulations under the REIT provisions state that "distribution procedures similar to those for regulated investment companies apply to non-REIT earnings and profits of a real estate investment trust."

New Federal Law (IRC Section 852, 856, and 857)

The Act made the following changes:

Investment limitations and taxable REIT subsidiaries.

General rule. Under the provision, a REIT generally cannot own more than 10% of the total value of securities of a single issuer, in addition to the present law rule that a REIT cannot own more than 10% of the outstanding voting securities of a single issuer. In addition, no more than 20% of the value of a REIT's assets can be represented by securities of the taxable REIT subsidiaries that are permitted under the Act.

Exception for safe-harbor debt.

For purposes of the new 10% value test, securities are generally defined to exclude safe harbor debt owned by a REIT (as defined for purposes of section 1361(c)(5)(B)(i) and (ii)) if the issuer is an individual, or if the REIT (and any taxable REIT subsidiary of such REIT) owns no other securities of the issuer. However, in the case of a REIT that owns securities of a partnership, safe harbor debt is excluded from the definition of securities only if the REIT owns at least 20% or more of the profits interest in the partnership. The purpose of the partnership rule requiring a 20% profits

interest is to assure that if the partnership produces income that would be disqualified income to the REIT, the REIT will be treated as receiving a significant portion of that income directly through its partnership interest, even though it also may derive qualified interest income through its safe harbor debt interest.

Exception for taxable REIT subsidiaries.

An exception to the limitations on ownership of securities of a single issuer applies in the case of a "taxable REIT subsidiary" that meets certain requirements. To qualify as a taxable REIT subsidiary, both the REIT and the subsidiary corporation must join in an election. In addition, any corporation (other than a REIT or a qualified REIT subsidiary under section 856(i) that does not properly elect with the REIT to be a taxable REIT subsidiary) of which a taxable REIT subsidiary owns, directly or indirectly, more than 35% of the vote or value is automatically treated as a taxable REIT subsidiary.

Securities (as defined in the Investment Company Act of 1940) of taxable REIT subsidiaries could not exceed 20% of the total value of a REIT's assets.

A taxable REIT subsidiary can engage in certain business activities that under present law could disqualify the REIT because, but for the proposal, the taxable REIT subsidiary's activities and relationship with the REIT could prevent certain income from qualifying as rents from real property. Specifically, the subsidiary can provide services to tenants of REIT property (even if such services were not considered services customarily furnished in connection with the rental of real property), and can manage or operate properties, generally for third parties, without causing amounts received or accrued directly or indirectly by the REIT for such activities to fail to be treated as rents from real property. However, rents paid to a REIT generally are not qualified rents if the REIT owns more than 10% of the value (as well as of the vote) of a corporation paying the rents. The only exceptions are for rents that are paid by taxable REIT subsidiaries and that also meet a limited rental exception (where 90% of space is leased to third parties at comparable rents) and an exception for rents from certain lodging facilities (operated by an independent contractor).

However, the subsidiary cannot directly or indirectly operate or manage a lodging or healthcare facility. Nevertheless, it can lease a qualified lodging facility (e.g., a hotel) from the REIT (provided no gambling revenues were derived by the hotel or on its premises), and the rents paid are treated as rents from real property so long as the lodging facility was operated by an independent contractor for a fee. The subsidiary can bear all expenses of operating the facility and receive all the net revenues, minus the independent contractor's fee.

For purposes of the rule that an independent contractor may operate a qualified lodging facility, an independent contractor will qualify so long as, at the time it enters into the management agreement with the taxable REIT subsidiary, it is actively engaged in the trade or business of operating qualified lodging facilities for any person who is not related to the REIT or

the taxable REIT subsidiary. The REIT may receive income from such an independent contractor with respect to certain pre-existing leases.

Also, the subsidiary generally cannot provide to any person rights to any brand name under which hotels or health care facilities are operated. An exception applies to rights provided to an independent contractor to operate or manage a lodging facility, if the rights are held by the subsidiary as licensee or franchisee, and the lodging facility is owned by the subsidiary or leased to it by the REIT.

Interest paid by a taxable REIT subsidiary to the related REIT is subject to the earnings stripping rules of section 163(j). Thus the taxable REIT subsidiary cannot deduct interest in any year that would exceed 50% of the subsidiary's adjusted gross income.

If any amount of interest, rent, or other deductions of the taxable REIT subsidiary for amounts paid to the REIT is determined to be other than at arm's length ("redetermined" items), an excise tax of 100% is imposed on the portion that was excessive. "Safe harbors" are provided for certain rental payments where (1) the amounts are de minimis, (2) there is specified evidence that charges to unrelated parties are substantially comparable, (3) certain charges for services from the taxable REIT subsidiary are separately stated, or (4) the subsidiary's gross income from the service is not less than 150% of the subsidiary's direct cost in furnishing the service.

In determining whether rents are arm's length rents, the fact that such rents do not meet the requirements of the specified safe harbors shall not be taken into account. In addition, rent received by a REIT shall not fail to qualify as rents from real property by reason of the fact that all or any portion of such rent is redetermined for purposes of the excise tax.

The Treasury Department is to conduct a study to determine how many taxable REIT subsidiaries are in existence and the aggregate amount of taxes paid by such subsidiaries and shall submit a report to the Congress describing the results of such study.

Health Care REITS.

The provision permits a REIT to own and operate a health care facility for at least two years, and treat it as permitted "foreclosure" property, if the facility is acquired by the termination or expiration of a lease of the property. Extensions of the 2 year period can be granted.

Conformity with regulated investment company rules.

Under the provision, the REIT distribution requirements are modified to conform to the rules for regulated investment companies. Specifically, a REIT is required to distribute only 90%, rather than 95%, of its income.

Definition of independent contractor.

If any class of stock of the REIT or the person being tested as an independent contractor is regularly traded on an established securities market, only persons who directly or indirectly own 5% or more of such class of stock shall be counted in determining whether the 35% ownership limitations have been exceeded.

Modification of earnings and profits rules for RICs and REITs.

The rule allowing a RIC to make a distribution after a determination that it had failed RIC status, and thus meet the requirement of no non-RIC earnings and profits in subsequent years, is modified to clarify that, when the sole reason for the determination is that the RIC had non-RIC earnings and profits in the initial year (i.e. because it was determined not to have distributed all C corporation earnings and profits), the procedure would apply to permit RIC qualification in the initial year to which such determination applied, in addition to subsequent years.

The Act clarifies the RIC and REIT earnings and profits ordering rules in the case of a distribution to meet the requirements that there be no non-RIC or non-REIT earnings and profits in any year.

Both the RIC and REIT earnings and profits rules are modified to provide a more specific ordering rule, similar to the present-law REIT rule. The new ordering rule treats a distribution to meet the requirement of no non-RIC or non-REIT earnings and profits as coming, on a first-in, first-out basis, from earnings and profits which, if not distributed, would result in a failure to meet such requirement. Thus, such earnings and profits are deemed distributed first from earnings and profits that would cause such a failure, starting with the earliest RIC or REIT year for which such failure would occur.

Rental income from certain personal property.

The provision modifies the present law rule that permits certain rents from personal property to be treated as real estate rental income if such personal property does not exceed 15% of the aggregate of real and personal property. The provision replaces the present law comparison of the adjusted bases of properties with a comparison based on fair market values.

Effective Date

The provision is effective for taxable years beginning after December 31, 2000. The provision with respect to modification of earnings and profits rules is effective for distributions after December 31, 2000.

In the case of the provisions relating to permitted ownership of securities of an issuer, special transition rules apply. The new rules forbidding a REIT to own more than 10% of the value of securities of a single issuer do not apply to a REIT with respect to securities held directly or indirectly by such REIT on July 12, 1999, or acquired pursuant to the terms of written

binding contract in effect on that date and at all times thereafter until the acquisition.

Also, securities received in a tax-free exchange or reorganization, with respect to or in exchange for such grandfathered securities would be grandfathered. The grand fathering of such securities ceases to apply if the REIT acquires additional securities of that issuer after that date, other than pursuant to a binding contract in effect on that date and at all times thereafter, or in a reorganization with another corporation the securities of which are grandfathered.

This transition also ceases to apply to securities of a corporation as of the first day after July 12, 1999 on which such corporation engages in a substantial new line of business, or acquires any substantial asset, other than pursuant to a binding contract in effect on such date and at all times thereafter, or in a reorganization or transaction in which gain or loss is not recognized by reason of section 1031 or 1033 of the Code. If a corporation makes an election to become a taxable REIT subsidiary, effective before January 1, 2004 and at a time when the REIT's ownership is grandfathered under these rules, the election is treated as a reorganization under section 368(a)(1)(A) of the Code.

The new 10% of value limitation for purposes of defining qualified rents is effective for taxable years beginning after December 31, 2000. There is an exception for rents paid under a lease or pursuant to a binding contract in effect on July 12, 1999 and at all times thereafter

Current California Law (R&TC Section 17088, 24870, 24872-24874)

California law conforms to the federal treatment of RICs and REITs with certain modifications. California is conformed to the federal treatment of a liquidating distribution from a RIC or a REIT prior to the enactment of the Tax and Trade Relief Extension Act of 1998. Additionally, California has not conformed to the modification made by IRS Restructuring and Reform Act of 1998 section 6012(g) relating to "earnings and profits" ordinary distributions of REITs.

The California modifications are:

- REIT taxable income does:
 - not include a deduction for dividends received,
 - not include a deduction for the tax imposed for not meeting the 95% or 75% income test,
 - include income from foreclosure property,
 - include income from prohibited transactions.
- Taxes on "income from foreclosed property," "income of a prohibited transaction," "alternative tax on capital gains" and failure to meet the 95% or 75% income test do not apply.

- A REIT is subject to the corporate minimum tax (currently \$800).
- A REIT cannot be part of a stapled group.

Additionally, to avoid other state and federal law differences as to whether a REIT will qualify as such for state purposes, California has a rule whereby if the REIT satisfies the distribution requirements of federal law so as to be treated as a REIT, it will be deemed to satisfy such requirements for state purposes (even if federal-state REIT income differences make it otherwise impossible for the REIT to satisfy the distribution requirements for state purposes).

Impact on California Revenue

The net revenue impact from conforming to these provisions would be a \$1 million in gain in 2000-01, \$4 million gain in 2001-02, and a \$2 million gain in 2002-03.

Revenue estimates above were based on federal projections for this provision in the Act.

Section Section Title

Modify Estimated Tax Rules for Closely Held REITs

Background

If a person has a direct interest or a partnership interest in incomeproducing assets (such as securities generally, or mortgages) that produce income throughout the year, that person's estimated tax payments must reflect the quarterly amounts expected from the asset.

However, a dividend distribution of earnings from a REIT is considered for estimated tax purposes when the dividend is paid. Some corporations have established closely held REITs that hold property (e.g. mortgages) that if held directly by the controlling entity would produce income throughout the year. The REIT may make a single distribution for the year, timed such that it need not be taken into account under the estimated tax rules as early as would be the case if the assets were directly held by the controlling entity. The controlling entity thus defers the payment of estimated taxes.

New Federal Law (IRC Section 6655)

The Act provides that in the case of a REIT that is closely held, any person owning at least 10% of the vote or value of the REIT is required to accelerate the recognition of year-end dividends attributable to the closely held REIT, for purposes of such person's estimated tax payments. A closely held REIT is defined as one in which at least 50% of the vote or value is

owed by five or fewer persons. Attribution rules apply to determine ownership.

No inference is intended regarding the treatment of any transaction prior to the effective date.

Effective Date

The provision is effective for estimated tax payments due on or after December 15, 1999.

Current California Law

California law does not contain any similar provisions that would require owners of a closely held REIT to accelerate the recognition of REIT dividends for estimated tax purposes.

Impact on California Revenue

The impact for conforming to this provision would result in revenue accelerations estimated to be \$1 million for fiscal year 2000-01 and less than \$100,000 annually thereafter.

Revenue estimates above were based on federal projections for this provision in the Work Improvement Act of 1999.

EXHIBIT A

EXPIRING TAX PROVISIONS

Calif. Sunset*	Calif. Section	Federal Section		ed. Sect. Description and Comments
01/01/00	24357.9	12/31/00 17	0(e)	Deduction: Augmented Corporate Computer Contributions
12/31/001	17053.49 23649	N/A N	N/A	Credit: Manufacturer's Investment
12/31/00	17279.4 24369.4	12/31/01 1	198	Deduction: Expensing of Environmental Remediation Costs (Brownfields)
12/31/01	17053.57 23657	N/A N	N/A	Credit: Community Development Financial Institution Deposits
12/31/01	17131	12/31/01	137	Deduction: Adoption Assistance
12/31/01	17502 24602	N/A N	N/A	Exclusion: California Stock Options
12/31/01	18715	N/A N	N/A	Voluntary Contribution: Children's Trust Fund for the Prevention of Child Abuse
12/31/01	18744	N/A N	N/A	Voluntary Contribution: Rare and Endangered Species Preservation Program
12/31/01	18844	N/A N	N/A	Voluntary Contribution: California Military Museum Fund
12/31/01	19283	N/A N	N/A	Collection of Amounts Due a Court
12/31/01	19568	N/A N	N/A	Collection: Delinquent Student Loans
12/31/02	17052.17 23638	N/A N	N/A	Employer Child Care Facility Credit
12/31/02	17052.18 23617.5	N/A N	N/A	Employer Dependent Care Plan Credit
12/31/02	17053.45 23645	N/A N	N/A	Credit: Sales and Use taxes Paid in the LA Revitalization Zone
12/31/02²	17053.46 23646	N/A N	N/A	Credit: Hiring in the Local Agency Military Base Recovery Area
12/31/02²	17268 24356.8	N/A N	N/A	Deduction: Expensing Business Property in Local Agency Military Base Recovery Area
12/31/02²	17276.2 24416.2	N/A N	N/A	Deduction: Net Operating Losses in the Local Agency Military Base Recovery Area
12/31/02	18796	N/A N	N/A	Voluntary Contribution: California Breast Cancer Research Fund
12/31/03	18785	N/A N	N/A	Voluntary Contribution: D.A.R.E. California (Drug Abuse Resistance Education) Fund
12/31/03	18816	N/A N	N/A	Voluntary Contribution: California Public

EXHIBIT A

EXPIRING TAX PROVISIONS

Calif. Sunset*	Calif. <u>Section</u>	Federa <u>Secti</u>		ed. Sect. Description and Comments
				School Library Protection Fund
12/01/03	18855	N/A	N/A	Voluntary Contribution: Emergency Food Assistance Program
12/31/04	18724	N/A	N/A	Voluntary Contribution: California Fund for Senior Citizens
12/31/04	18766	N/A	N/A	Voluntary Contribution: Alzheimer's Disease and Related Disorders Research Fund
12/01/04	18824	N/A	N/A	Voluntary Contribution: Mexican American Veterans' Memorial Account
12/31/04	18865	N/A	N/A	Voluntary Contribution: Birth Defects Research Fund
13/31/05	18804	N/A	N/A	Voluntary Contribution: California Firefighter Memorial Fund
12/31/05	18807	N/A	N/A	Voluntary Contribution: California Peace Officer Memorial Fund
01/01/06	17053.36 17053.37 23636 23637	N/A	N/A	Credit: Joint Strike Fighters Wage & Property
12/31/07	17052.10 23610	N/A	N/A	Credit: Rice Straw

Footnotes

- * In general, this is the last taxable year to which the provision applies. Fiscal years beginning within this taxable year are, in general, also covered by the provision. In some cases, the expiration applies to transactions occurring after this date.
- ¹ The actual date this provision expires is unknown at this time. The law provides that the credit will expire on January 1, 2001, or on January of the earliest year thereafter, if the total employment in this state on the preceding January 1 does not exceed by 100,000 jobs the total employment in this state on January 1, 1994. EDD is to make this determination. It is expected that the total employment will exceed the 100,000 jobs threshold for 2000 year.
- ² The LAMBRA provisions expire eight years after the Trade & Commerce Agency (TCA) designates an area as a LAMBRA. The TCA is authorized to designate eight LAMBRAs in the state. As of January 2000, three areas have been designated and the remaining five sites have received conditional designations. The expiration date listed for LAMBRAs is the earliest date the tax preferences or incentives will expire.

EXHIBIT B

REVENUE ESTIMATES FOR CONFORMING TO 1999 FEDERAL CHANGES

Act			(in millions)		
Sect.	Act Title	Notes	2000-1	2001-2	2002-3
1	Tax Benefits of Military Personnel Serving in Combat Zones Extended to Hazardous Duty Area	N/A	-	-	-
3001	Property Subject to a Liability Treated in Same Manner as Assumption of Liability		\$1	\$1	\$1.5
650	Itemized Income Tax Receipt	N/A	-	-	-
405	Authorization for States to Permit Annual Wage Reports	EDD	-	-	-
412	Simplification of Foster Child Definition under Earned Income Credit	N/A	-	-	-
501	Extend Minimum Tax Relief for Individuals		Negl. Loss	Negl. Loss	Negl. Loss
502	Extend Research and Experimentation Tax Credit And Increase Alternative Incremental Rate (conform at 80% of new federal rates)		(\$13)	(\$22)	(\$27)
503	Extend Exceptions Under Subpart F for Active Financing Income		(\$0.5)	(\$0.5)	(\$0.5)
504	Extend the Suspension of Net Income Limitation on Percentage Depletion fro Marginal Oil and Gas Wells	om	(\$0.5)	(\$1)	(\$0.5)
505	Extend the Work Opportunity and Welfare-To-Work Tax Credits	N/A	-	-	-
506	Extend Exclusion for Employer-Provided Educational Assistance	N/A	-	-	-
507	Extend and Modify Tax Credit For Electricity Produced by Wind and Closed-Loop Biomass Facilities	N/A	-	-	-
508	Extend Duty-Free Treatment Under Generalized System of Preferences	N/A	-	-	-
509	Extend Authority to Issue Qualified Zone Academy Bonds	N/A	-	-	-
510	Extend the Tax Credit for First-Time D.C. Homebuyers	N/A	-	-	-
511	Extend Expensing of Environmental Remediation Expenditures		(\$1)	(\$2)	Minor Loss
512	Temporary Increase in Amount of Rum Excise Tax	BOE	-	-	-
521	Prohibit Disclosure of Advance Pricing Agreements	N/A	-	-	-
522	Authority to Postpone Certain Tax-Related Deadlines Due to Year 2000 Failures		Negl. Loss	Negl. Loss	Negl. Loss
523	Add Certain Vaccines Against Streptococcus Pneumonia to the List of Taxable Vaccines	BOE	-	-	-
524	Delay Requirement That Registered Motor Fuels Terminal Offer Dyed Fuel as a Condition of Registration	BOE	-	-	-
525	Provide That Federal Production Payments to Farmers are Taxable in the Year Received		Negl. Impact	Negl. Impact	Negl. Impact
531	Modification of Individual Estimated Tax Safe Harbor		(\$1.5)	\$3	(\$1.5)
532	Clarify the Tax Treatment of Income and Losses from Derivatives		Negl. Gain	Negl. Gain	Negl.Gain
533	Information Reporting on Cancellation of Indebtedness by Non-Bank Financial Institutions		Negl. Gain	Negl. Gain	Negl. Gain
534	Limit Conversion of Character of Income from Constructive Ownership Transactions		\$1	\$1	\$1
535	Treatment of Excess Pension Assets Used for Retiree Health Benefits	a/			
	Modify Installment Method and Prohibit Use by Accrual Method Taxpayers		\$30	\$12	\$8
537	Denial of Charitable Contribution Deduction for Transfers Associated with Splinsurance Arrangements	it-Dollar		Negl. Gain	Negl. Gain
538	Distributions by a Partnership to a Corporate Partner of Stock In Another Corporation		Minor Gain	Minor Gain	Minor Gain
541 - 547	Income and Services Provided by Taxable REITs Subsidiaries		\$1	\$4	\$2
571	Modify Estimated Tax Rules for Closely Held REITs		\$1	Negl. Gain	Negl. Gain
	Totals		\$17.5	(\$4.5)	(\$17.0)

Negligible = Loss (or gain) less than \$250,000

Minor = Loss (or gain) less than \$500,000

N/A = Not Applicable

EDD = Defer to Employemnt Development Department

BOE = Defer to Board of Equalization

a/ Baseline gains from reduced business deductions are estimated at less

than \$500,000 in 2000-1 and \$1 million each in 2001-2 and 2002-3.

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